GEORGIA DEPARTMENT OF REVENUE

LOCAL GOVERNMENT SERVICES DIVISION

Basic Accounting Workshop

For Educational Purposes Only:

The material within is intended to give the course participant a solid understanding of general principles in the subject area. As such, the material may not necessarily reflect the official procedures and policies of the Georgia Department of Revenue or the Department's official interpretation of the laws of the State of Georgia. The application of applicability to specific situations of the theories, techniques, and approaches discussed herein must be determined on a case-by-case basis.

Revised August 2017

Course Description

The Basic Accounting course adheres to the requirements of O.C.G.A. § 48-5-268 (b)(1):

48-5-268 Training courses for new appraisers; continuing education for experienced appraisers; member of county appraisal staff to appraise tangible personal property

(b)(1) The department shall prepare, instruct, operate and administer courses of instruction for the training of new appraisers and the continuing education of experienced appraisers in the appraisal of personal property.

(2) In all counties except Class I counties, the chief appraiser shall designate at least one person on the county appraisal staff to be responsible for the appraisal of tangible personal property.

Any person or persons so designated shall be required to attend the standard approved training courses operated by the department in accordance with this subsection as part of their duties specified in subsection (b) of Code Section 48-5-263.

The course is designed to provide the participants with a basic knowledge and understanding of introductory accounting terminology, techniques, and principles. The objectives of the course are: (1) development of a general understanding of financial reports and accounting analysis, (2) knowledge of basic accounting terminology and transactions, and (3) preparation for the Verification of Personal Property Course.

The course utilizes lectures, quizzes, group activities, homework and classroom discussions to familiarize the participant with simple accounting documents as well as the basic relationship between assets, liabilities, and owner's equity (capital). Students are encouraged to actively participate. Classroom participation will be monitored by instructor on a daily basis.

The following topics will be covered during the course:

1. Introduction to Accounting and Business
2. The Accounting Equation
3. The Accounting Cycle
4. Financial Statements
5. Inventory Costing Methods
6. Fixed Assets and Depreciation

There is a fifty question exam on the last day of class. The GCP coordinator assigned to this course will send the results of the final examination to the account associated with the email address indicated on the credit form located on the back of your answer sheet. Credit for courses will be awarded to students that have met the mandatory 95% attendance requirement of 18 hours out of the 20 hours offered for this course, the completion of required coursework and a passing score of seventy percent or better on the final examination. Student's failure to pass exam can retake exam for $25 during the next regional exams at Southmeadow if registered within 2 weeks of results letter date or pay to retake course.

Introduction to Accounting and Business

What is accounting? Accounting is the language of business. The accounting system records the economic data about business activities and events which can be provided to users that need accounting information to make good judgments and sensible business decisions. For example, accounting data on a business's product provides management with information to continue or to discontinue carrying a product. Creditors such as banks or suppliers use accounting data to determine the risk of loaning a client capital. Investors use accounting data to decide whether to invest in a security such as a stock, mutual fund or ETF. As a government agency, we use accounting data as a basis for assessing taxes on property owned by an individual or company.

Users	Use
Individuals	Individuals must understand accounting to function personally within our society, which is very dependent on financial activities. We keep checkbooks and other bank accounts, receive paychecks, pay taxes, use charge cards, borrow money, and purchase a variety of goods and services.
Owners	Business owners must understand accounting to achieve success in their organizations. Often, owners do not actually run the business. In these cases, owners rely on accounting information to determine how well their businesses are being managed.
Managers	Managers use accounting data extensively. The information is used to decide on alternatives, such as what to sell, how to price, and when to expand, contract, or change the product line.
Investors	Investors use accounting data for insights on the financial conditions of potential investments.
Banks and other lending institutions	Lenders use accounting data in deciding whether or not to approve a loan.
Governments	Governmental units, at all levels, also record, summarize, analyze, and interpret financial events to operate with limited resources.
Taxing Authorities	Tax authorities' use accounting data reported to the government in deciding whether or not a business, or individual, is complying with tax laws and regulations. Since our country has an extensive taxing system, this is a major use of accounting data.

In other words, accountants must present an organization's financial information in clear, concise reports that help answer questions a user may have about an organization. Below are some common questions asked by users of financial records and reports created by accountants:

1. Has the company acquired or leased property?
2. How much debt does a company have?
3. How often does a company turnover inventory?
4. How many supplies does a company have on hand at the end of the year?

5. What was the ending balance for raw material, work in process and finished goods inventory?

Accounting is commonly thought of as being a very narrow, specialized field that only is useful for a small part of our society. This is not a correct impression. Instead, accounting is diverse in its responsibilities and activities. Every individual and every organization in America needs accounting. Accounting goes beyond bookkeeping, the recording of economic events. The accounting process involves not only the recording of the economic events of an entity, but also the measuring, analyzing and classifying of the economic or financial transactions of an entity and then the reporting or disclosing of such economic activity in the form of financial statements. More simply and practically stated, accounting is the process of recording and reporting correctly the purchase and sale of goods and services by business entities.

The personal property appraiser should be familiar with basic accounting principles, concepts and methods to aid in reviewing the taxpayer's return and analyzing the financial records. The appraiser can use accounting records to obtain information such as service life and historical cost or analyze the taxpayer's habits such as purchase and disposal history of fixed assets or how often the company turns over inventory. The appraiser can also use accounting data of a similar business to determine the value for fixed assets and inventory for a business who fails to make a return.

Nature of a Business

A business provides goods and services to customers in exchange for money. A business's customers can be individuals and/or other businesses. Most businesses are in operation to maximize profits known as "for profit businesses" and others exist to provide some social benefit to others known as "not for profit businesses." Profit is the difference in the sale of a business's goods and services to the customer and the cost of those goods and services paid for by the business.

The most common types of businesses are the service industry, the merchandising industry, and the manufacturing industry.

A service business performs services for customers to earn a profit. Examples of service businesses include accountants, doctors, lawyers, appraisers, and beauty salons to name a few.

Merchandising businesses purchases goods produced by others and then sell those goods to others. Examples of merchandising businesses include department stores, supermarkets, and antique dealers.

A manufacturing business manufactures (produces, fabricates, assembles) products or goods for sale to others. Examples of manufacturing businesses include automakers, appliance makers, furniture makers, paper mills, steel mills, and carpet mills.

Identifying the type of business is important for Freeport exemptions.

Basic Accounting Principles and Concepts

In accounting, the business entity concept states a business or an organization and its owners are treated as two separately identifiable parties. The business stands apart from other organizations as a separate economic unit. Examples of businesses are sole proprietorship, partnership, and corporation. Business organizations may also operate as one of several “hybrid” entities such as S corporations, limited liability companies and limited partnerships.

A sole proprietorship is a business owned by one person. The owner is called the proprietor and receives all of the profits and is responsible for all of the obligations of the business. The owner pays no separate income taxes and includes income of the sole proprietorship on his or her personal tax return. Creditors can attach the sole proprietor’s personal non business assets to satisfy proprietorship liabilities. However, for accounting purposes separate accounting records are maintained for the business proprietorship and the individual’s personal assets and liabilities. Common federal tax forms and schedules used by sole proprietor: Form 1040, Schedule C (Profit or Loss from Business).

A partnership is a form of business that is co-owned by two or more persons. The partners enter into a contract that sets forth how the business will run and how the profits or losses will be divided. A partnership as an entity generally pays no income taxes but rather the partners include their share of partnership income on their personal tax returns. Similar to sole proprietorships, partners are personally liable for the partnership debts or liabilities. In other words, partnership creditors can attach a partner’s personal non-business assets to satisfy partnership debts or liabilities. Common federal tax forms used by a partnership: Form 1065, Schedule E (Supplemental Income or Loss).

A corporation is a form of business organization in which the owners or shareholders are not personally liable for corporate debts or liabilities. The owners or shareholders are only liable to the extent of their investment in the corporation or corporate assets. In other words, creditors generally cannot attach the personal non-business assets of the owners or shareholders to satisfy corporate debts or liabilities. However, corporations do pay taxes as a separate entity so a corporation’s income is subject to double taxation. The corporation pays corporate income tax on its income and the owners or shareholders pay income tax on their individual income tax returns on dividends and other similar distributions made by the corporation. Common federal tax form used by a corporation: Form 1120.

The “hybrid” type entities such as S corporations, limited liability companies and limited partnerships generally don’t pay tax at the entity level but rather the owners pay the income tax of such entities on their personal income tax returns. Consequently, no such income is subject to double taxation. In addition, owners of these “hybrid” entities are not personally liable for S corporation, limited liability company or limited partnership debt. These entities enjoy the “best of both worlds” in that their income is taxed only once and creditors of such entities can’t attach any personal assets of the owners. Common federal tax forms for S corporations, LLCs and LPs: Form 1065 (Partnership), Form 1120 (Corporation), Form 1120S (S Corporation).

The reliability concept states that accounting records and statements must be based on the most reliable data available. The data must be verifiable and capable of being confirmed by any independent observer.

The cost principle states that assets should be recorded at the actual cost paid at the time of acquisition, not current value. The actual cost is also sometimes called the historical cost. The historical cost is the cost incurred to acquire the asset (as opposed to replacement cost, or cost adjusted by a general cost index). Actual cost to any given owner of an asset may not be the original historical cost of the asset. It will be the cost to the current owner.

The going concern concept assumes that an entity will remain in operation long enough to use the assets for their intended purpose. The market value of an asset or group of assets may change over the life of the assets and will be different than the actual or historical cost of the asset in any given year.

The stable monetary unit concept assumes that the dollar's purchasing power is relatively stable. This concept ignores the effect of inflation in the accounting records; therefore the cost of an asset may not equal its fair market value.

The matching principle requires accountants to match expenses against revenues or to subtract the expenses from the revenues in order to report a company's profitability during a specific time interval.

The business economic entity principle states that a business is a distinct economic unit that is separate from its owner and separate from any other business. Financial records must be separately maintained for each economic activity. Economic entities include businesses, governments, school districts, churches and other social organizations. Even though different entities may be combined for financial reporting purposes, every economic event must be associated with and recorded by a specific entity. Personal assets and debts of the owner must not be included with business records.

Accountants follow the above principles and concepts to maintain a company's accounting records which do not necessarily reflect fair market value. Being familiar with accounting concepts will aid the personal property appraiser to make adjustments when necessary.

Financial Accounting versus Tax Accounting

Financial statements are prepared according to agreed upon guidelines. In order to understand these guidelines, it helps to understand financial reporting. The objectives of financial reporting, as discussed in the Financial Accounting Standards Board (FASB) *Statement of Financial Accounting Concepts No. 1*, are to provide information that

- is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions;

- helps present and potential investors and creditors and other users to access the amounts, timing, and uncertainty of prospective net cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans;

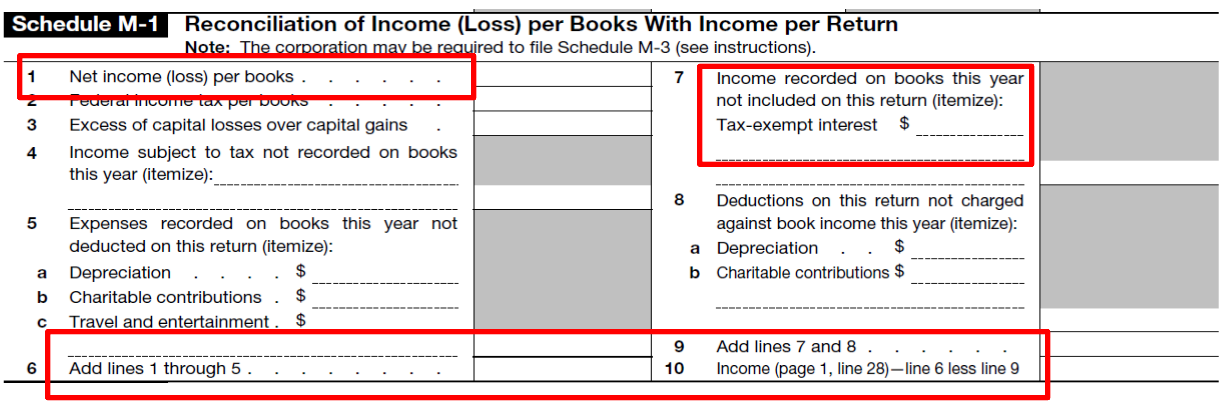
- identifies the economic resources of an enterprise, the claims to those resources, and the effects that transactions, events, and circumstances that change its resources and claims to those resources.

Financial accounting is the branch of accounting that is concerned with recording transactions using generally accepted accounting principles (GAAP) for a business or other economic unit and with a periodic preparation of various statements from such records which are helpful to users external to the organization. GAAP governs accounting. These principles may be described as broad rules adopted by the accounting profession as guides in measuring, recording, and the reporting or disclosing of the financial or economic activities of a business in the form of financial statements. Establishment of GAAP began with Congress. In 1933 and 1934, Congress created the Securities and Exchange Commission (SEC). The SEC was given power to prescribe the accounting principles and practices to be followed by companies under its jurisdiction. Companies under the jurisdiction of the SEC are principally companies whose debt and/or equity securities or stock are publicly traded. The SEC subsequently turned to the American Institute of Certified Public Accountants (AICPA) for guidance in establishing accounting principles. The AICPA appointed members to serve on a policy setting board known as the Financial Accounting Standards Board (FASB).

The importance of GAAP in the accounting industry is similar to the importance of the Appraisal Procedures Manual (APM), passed into law by the Georgia General Assembly, provides the local tax assessing officials in the 159 counties with uniform procedures to be used in the appraisal of real and personal property for property tax purposes. These standard set of rules (APM) along with statistical guidelines (sales ratio study) must be adhered to by the counties. Users such as the taxpayers, Department of Revenue (DOR) and Department of Accounts and Audits (DOAA), can reference these rules to ensure the burden of taxation is distributed equally among the citizens of the State. Likewise, a standard set of generally accepted accounting principles allows investors to compare financial performance and condition among companies.

A company is allowed to keep a set of books for internal accounting and a second set of books for income tax reporting. Tax accounting focuses on taxes rather than the appearance of public financial statements. Under the United States tax code, corporations and individuals must pay federal, state, and local income taxes, depending on where they are located. Income tax accounting is governed by the Internal Revenue Code (IRC) which was established by Congress in Title 26 of the United States Code. It is a collection of all federal tax laws. It covers income tax, payroll taxes, estate taxes, gift taxes and excise taxes as well as procedure and administration. The IRC is implemented by the Internal Revenue Service (IRS).

Income measured in accordance with GAAP is not always the same as taxable income required by tax statutes. Realization and recognition are key concepts in understanding the difference between tax accounting and financial accounting; realization and recognition deal with the timing and manner of reporting. For instance, municipal bonds are a debt security issued by a state, municipality or county to finance its capital expenditures such as the construction of highways, bridges or schools. They are purchased for their favorable tax implications. State and municipal bond interest is exempt from federal income tax. However, the same state or municipal bond interest is income to the recipient and includable as income under GAAP. Schedule M-1 from Form 1120, U.S. Corporation Income Tax Return, deducts tax exempt interest from line 6 (gross income), therefore, municipal bonds would not be taxable.



Schedule M-1 **Reconciliation of Income (Loss) per Books With Income per Return**

Note: The corporation may be required to file Schedule M-3 (see instructions).

1	Net income (loss) per books		7	Income recorded on books this year not included on this return (itemize): Tax-exempt interest $	
2	~~Federal income tax per books~~				
3	Excess of capital losses over capital gains				
4	Income subject to tax not recorded on books this year (itemize):		8	Deductions on this return not charged against book income this year (itemize):	
5	Expenses recorded on books this year not deducted on this return (itemize):		a	Depreciation $	
a	Depreciation $		b	Charitable contributions $	
b	Charitable contributions $				
c	Travel and entertainment $		9	Add lines 7 and 8	
6	Add lines 1 through 5		10	Income (page 1, line 28)—line 6 less line 9	

Another difference between financial and tax accounting reporting is the depreciation of equipment. Under GAAP, a company purchases equipment and depreciates the equipment over its useful life. Under the IRC, instead of writing a piece of equipment off over so many years, the company can elect to expense all or part of the cost of certain qualifying property, up to a limit, by deducting in the year it was placed in service whether it was purchased or leased. The deduction is called Section 179 of the IRS tax code. It's an incentive created by the U.S. government to encourage businesses to buy equipment to stimulate the economy. For example, a company purchases equipment in 2014 for $50,000 to be used in its business. The company estimates it will be in use for 5 years. For financial accounting purposes, it will get to write off $10,000 a year for five years. If they elect the Section 179 deduction, the company can write off $25,000 plus first year depreciation percentage determined by the IRS cost recovery schedule.

2014 Section 179 Deduction	
Equipment Purchases	$50,000
First Year Write Off: ($25,000 = maximum in 2014)	25,000
50% Bonus First Year Depreciation	0
Normal first Year Depreciation (20% in each of 5 years on remaining amount) 20% x $25,000	5,000
Total First Year Deduction: ($25,000 + $5,000)	**30,000**

Therefore, the Section 179 deduction of $30,000 is more favorable to the taxpayer when completing tax returns than the $10,000 depreciation for financial accounting purposes.

Elements of Financial Statements

According to FASB, the elements or accounts of financial statements are the building blocks or account types with which financial statements are constructed—the broad classes of accounts that financial statements comprise. In its “Elements of Financial Statements of Business Enterprise,” the FASB defined the interrelated elements or accounts that are directly related to measuring performance and the financial position of a business enterprise as follows:

- **Assets** include any items of monetary value owned by a company with current (expected to be collected within one year) or probable future economic benefits. In other words, the cash, accounts receivable (asset arising from selling goods and services on credit to customers) merchandise, and other property needed to carry on the operations of a business.

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- **Liabilities** are current (liability due within the coming year) or probable future debts arising from present obligations of a company to transfer assets or provide services to other entities in the future as a result of past transactions or events. Simply stated, should the owner of a business agree either in writing or verbally to pay at a later date for the merchandise or service purchased, the owner has incurred an obligation or debt also known as a liability. An example is accounts payable which is a liability that results from purchasing goods and services on credit.

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- **Equity or owner’s equity or capital** refers to the value of a company after deducting a company’s liabilities from its assets.

- **Revenues** are sales or other enhancements of assets of a company or settlement of its liabilities (or both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations.

- **Expenses** are outflows or payments of assets, or obligations to pay liabilities, during a period, from delivering or producing goods or rendering services as well as from carrying out other activities that constitute part of a business’s ongoing central operation.

- **Gains** are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period, except those that result from revenues or investments by owner.

- **Losses** are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period, except those that result from expenses or distributions to owners.

- **Investments by owners** are increases in net assets of a particular enterprise resulting from transfers to it from other parties of something of value to obtain or increase ownership interest in it.

- **Distributions to owners** are decrease in net assets of a particular enterprise resulting from transferring assets, rendering services, or incurring liabilities to owners. Distributions to owners decrease ownership interest or equity in an enterprise.

- **Comprehensive income** is the change in equity (net assets) of an entity from transactions and other events and circumstances form non owner sources, during a particular period. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

NOTE: These elements are constantly changing

The effect of every transaction is an increase or decrease in one or more of the accounting equation elements.

The Accounting Equation

The relationship between the accounting elements can be expressed in a simple mathematic form known as the accounting equation:

ASSETS = LIABILITIES + OWNER'S EQUITY

Or in symbol form:

A = L + OE

Assets are the resources owned by a business. Examples of assets include cash, land, buildings, and equipment. The rights or claims to the properties are normally divided into two principal types: (1) the rights of creditors and (2) the rights of owners. The rights of creditors represent debts of the business and are called liabilities. The rights of the owners are called owner's equity.

The accounting equation provides a basic framework for recording the effects of transactions on companies of all sizes and types. The basic framework serves as the foundation for accounting systems form the smallest business, such as a local convenience store, to the largest businesses.

For example, on December 31, 2004, if John Smith had business assets of $50,000, business liabilities of $20,000, and owner's equity of $30,000. His accounting equation is:

Assets	**=**	**Liabilities**	**+**	**Owner's Equity**
$50,000	**=**	**$20,000**	**+**	**$30,000**
$50,000	**=**	**$50,000**		

Note that the left side of the equation (the asset side) balances with the right side of the equation (the liabilities and owner's equity side). To maintain this balance, transactions are recorded as having a dual effect on the basic accounting elements. Also, note that in the accounting equation, liabilities are placed before owner's equity. This is done because the creditor's claims to assets take legal priority over the owner's claim to assets. Finally, it should be noted that if two elements of the equation are known, the third can always be found.

Find the missing element in each of the following:

A	=	L	+	OE
$40,000	=	$25,000	+	
	=	$38,000	+	$52,000
$70,000	=		+	$48,000

Chart of Accounts (COA)

A chart of accounts is a numerical listing of the names of all the accounts used by an organization. Different type of businesses will have different accounts customized to meet the needs of the business (i.e. service business, merchandising business or manufacturing business). These accounts are divided into the three elements of the financial statements.

Assets

Asset accounts are classified in two major categories, current assets and long-term assets.

Current Assets	Long-term Assets
Cash	Land
Investments	Buildings
Accounts Receivable	Improvements
Inventory (Finished Products)	Machinery and Equipment
Raw Materials	Construction in Progress
Prepaid Items	
Consumable Supplies	

= Liabilities

Liability accounts are also classified in two categories, current liabilities and long-term liabilities.

Current Liabilities	Long-term Liabilities
Accounts Payable	Notes Payable
Contract Payable	Mortgages Payable
Accrued Wages Payable	Installment Notes Payable
Accrued Taxes Payable	

+ Owner's Equity

Equity or capital accounts are defined as the interest of the owners in an enterprise. The owner's equity is increased by amounts invested by the owner and is decreased by withdrawals by the owner. In addition, the owner's equity is increased by revenues and is decreased by expenses.

Sole Proprietor or Partnership	Corporations
Capital	Common Stock
Drawing	Preferred Stock
	Retained Earnings

Chart of Accounts Example

Hughes and Associates

Chart of Accounts

Assets (100-199)		**Owner's Equity (300-399)**	
111	Cash	311	C. Michelle Hughes, Capital
112	Accounts Receivable	312	C. Michelle Hughes, Drawing
113	Office Supplies		
116	Office Equipment	**Revenue (400-499)**	
117	Office Equipment	411	Service Revenue
Liabilities (200-299)		**Expenses (500-599)**	
211	Accounts Payable	511	Rent Expense
		512	Repairs Expense

The numbering scheme shown above is a three-digit, five-category plan with the first digit indicating the category of account (1=asset, 2=liability, 3=owner's equity, 4=revenue, and 5=expenses). The second and third digits indicate the position of the individual accounts within their particular classifications. Often a gap is left between the account numbers so that new accounts can be added in the future at the appropriate place in the ledger.

The COA is a starting point for the appraiser to substantiate personal property returned or discover inventory, MEFF (machinery, equipment, fixtures, furniture) and other taxable personal property not reported by the property owner. If the books are properly kept, the taxpayer will have an account representing assets acquired, disposed and leased.

Review

Fill in the blanks with the following terms.

manufacturing	assets	classifying	service	partnership
measuring	merchandise	Sole proprietor	limited liability corporation	s corporation
users	business	tax accounting	owner's equity	publicly traded
economic data	recording	analyzing	limited partnership	corporation
GAAP / capital / liabilities / dual effect / accounts receivable / net income / accounts payable / business entity				

1. Accounting is the language of ______________________________.

2. The accounting system records the ________________ about business activities and events which can be provided to _______________ that need accounting information to make good judgments and sensible business decisions.

3. The accounting process involves not only the _______________ of the economic events of an entity, but also the_____________, _____________ and ______________ of the economic or financial transactions of an entity and then the reporting or disclosing of such economic activity in the form of financial statements.

4. The most common types of businesses are the ____________ industry, the ___________ industry, and the _________________ industry.

5. Businesses can be formed as a ____________________, _____________________, and _____________________. Business organizations may also operate as one of several “hybrid” entities such as _____________________, ____________________ and _________________________________.

6. Financial accounting is the branch of accounting that is concerned with recording transactions using _______________________________ for a business or other economic unit.

7. ________________________ focuses on taxes rather than the appearance of public financial statements.

8. Companies under the jurisdiction of the Securities and Exchange Commission are principally companies whose debt and/or equity securities or stock are ______________ ______________________.

9. _______________ are items with money value that are owned by a business.

10. The liability that results from purchasing good and services on credit is called ________________.

11. The asset arising from selling goods and services on credit to customers is called ________________.

12. The difference between assets and liabilities is the part of the business that the owner can claim. It is called ________________.

13. The accounting equation can be stated as ________________ equal ________________ plus ________________.

14. The ________________ concept states that a business is a distinct economic unit that is separate from its owner and separate from any other business.

15. In order to maintain the balance of the accounting equation, transactions are recorded as having a(n) ________________ on the basic accounting elements.

16. When revenues are greater than expenses, a(n) ________________ results.

The Accounting Cycle

The accounting cycle is the standard sequence of steps or procedures used by a company to record and summarize accounting data. The accounting process begins with an analysis of transactions recorded on source documents such as invoices and checks; it ends with the completion of a post-closing trial balance. The cycle consists of the following steps:

During the accounting Period	Step 1. Analyze transactions from source documents. Step 2. Record transactions in a journal. Step 3. Post from the journal to the ledger. Step 4. Prepare a trial balance of the ledger.
At the end of the accounting period	Step 5. Determine needed adjustments. Step 6. Prepare a worksheet. Step 7. Journalize and post adjusting entries. Step 8. Prepare financial statements. Step 9. Journalize and post closing entries. Step 10. Prepare a post closing trial balance.

Steps one through three occurs as often as needed during an accounting period. Steps four through six occurs at the end of each accounting period. Steps nine and ten usually occur only at the end of each accounting period or fiscal year.

Fiscal Period

A fiscal period is any period of time covering the complete accounting cycle. The annual accounting period adopted by a business is known as its fiscal year. For some businesses, a fiscal year does not have to coincide with the calendar year. Many businesses have seasonal peaks. For those businesses, it is logical to end the accounting period at the point in the operating cycle in which business activity is the lowest. A fiscal year ending at the business's lowest point of activity is referred to as a natural business year.

Business Transactions

As mentioned earlier, the value of a firm's assets, liabilities and owner's equity change constantly as the firm goes about normal day to day activities. Any activity that changes one of the above is called a transaction. Any event that does not cause such a change is not a transaction. For example, firing an employee causes no change in the value of the business' assets, liabilities, or owner's equity; therefore, it is not considered a transaction.

Business Transaction Examples

Purchase of equipment on credit
Cash payments to a creditor
Receipts of cash for performing services
Purchase of supplies for cash
Payment of rent for the month
Owner investment of cash in the business

A business transaction is initially recorded in a journal, also referred to as the book of original entry. Similar to a diary, it is a record with entries arranged by date reporting what has happened in a business over a course of a day or other period. The account to be debited is listed first, followed by the amount to be debited. The account to be credited is listed below and to the right of the debit, followed by the amount to be credited. The process of recording a transaction in the journal is called journalizing. This form of recording a transaction is called a journal entry. These individual entries will be utilized to develop the financial statements. Below a two column journal is represented recording cash invested in a business by the owner.

General Journal Page 1

	Date		Account Title	P.R.	Debit					Credit					
1	20X9 Oct	1	Cash		10	0	0	0	00						1
2			C. Michelle Hughes, Capital							10	0	0	0	00	2
3			Invested cash in the business												3
4															4
5															5
6															6

We will discuss the rules of debits and credits and simplify journaling later using T accounts.

Rules of Debit and Credit

As stated in the basic accounting equation, total assets must always equal liabilities plus owner's equity. The accounting equation must always balance. To maintain this balance, transactions are recorded as having a dual effect on the basic accounting elements. For example, a company purchases equipment for $5,000 on credit. This transaction has two effects on the accounting elements: (1) since an asset was acquired, assets increase; and (2) since the asset was bought on credit, liabilities also increase.

ASSETS	=	LIABILITIES	+	OWNER'S EQUITY
+5,000	=	+5,000		
Equipment		Accounts Payable		

Assets (on one side of the equation) increased by $5,000, while liabilities (on the other side of the equation) increased by $5,000, thus maintaining the equation in balance. Every business transaction has at least two effects on the accounting equation, hence the name Double Entry Accounting, both which are recorded in the accounting records. The objective of double-entry accounting is to make equal debit and credit entries into the proper ledger accounts. It does not mean that each transaction is recorded twice. When making dual entries, an account can either be debited and/or credited. Debit and credit can mean either increase or decrease. This is dependent on what kind of account is receiving the entry. The rules of debit and credit are the left side of the account is the debit side and the right side of the account is the credit side. To debit an account means to enter an amount on the left side and to credit an account means to enter an amount on the right side. The abbreviations Dr. and Cr. are commonly used for debit and credit, respectively.

DO NOT THINK IN TERMS OF DEBIT AND CREDIT MEANING INCREASE OR DECREASE; ONLY THINK OF THEM AS MEANING LEFT AND RIGHT.

ACCOUNT TITLE

Debit	Credit
Left Side	Right Side
Dr.	Cr.

The rules for debit and credit are best understood if related back to the left and right side of the account equation.

ASSETS (LEFT) = LIABILITES + OWNER'S EQUITY (RIGHT)

Rule of Thumb: Assets are on the left side of the equation; debit is on the left side of the account. Therefore, assets increase on the debit (left) side. Liabilities and owner's equity are on the right side of the equation; credit is on the right side of the account. Therefore, liability and owner's equity accounts are increased on the credit (right) side. Some exceptions apply to temporary owner's equity accounts which will be discussed later.

ASSETS		=	LIABILITES		+	OWNER'S EQUITY	
Debit	Credit		Debit	Credit		Debit	Credit
Left Side	Right Side		Left Side	Right Side		Left Side	Right Side
Dr.	Cr.		Dr.	Cr.		Dr.	Cr.
+	-		-	+		-	+

Since an account has only two sides the decrease side is always opposite of the increase side. Therefore, since asset accounts are increased by debits they must be decreased with credit entries. The opposite are true of liability and owner's equity accounts, since they are increased by credits they must be decreased by debit entries. This is illustrated utilizing T Accounts as shown above. The T Account is a skeletal version of the standard form of an account (which will be discussed later) and derives its name from looking like a capital letter "T." The T Account provides the same basic data as the standard form of account: (1) the account title, (2) the debit side, and (3) the credit side. T Accounts are very useful for learning purposes. Adhere to the three directives below to record transactions:

1. Determine whether an asset, a liability, owner's equity, revenue or expense account is affected by the transaction.
2. For each account affected by the transaction, determine whether the account increases or decreases.
3. Determine whether each increase or decrease should be recorded as a debit or a credit.

The following examples will use T accounts to illustrate the rules of debit and credit.

(A) Ms. Hughes invested $10,000 cash to start her business.

CASH

DEBIT	CREDIT
(A) 10,000	

MS. HUGHES, CAPITAL

DEBIT	CREDIT
	(A) 10,000

(B) Purchased office equipment for $3,000 on account.

OFFICE EQUIPMENT

DEBIT	CREDIT
(B) 3,000	

ACCOUNTS PAYABLE

DEBIT	CREDIT
	(B) 3,000

(C) Purchased office supplies for $125.

OFFICE SUPPLIES

DEBIT	CREDIT
(C) 125	

CASH

DEBIT	CREDIT
(A) 10.000	**(C) 125**

(D) Paid $500 on equipment purchase in Transaction (B)

CASH

DEBIT	CREDIT
(A) 10,000	(C) 125
	(D) 500

ACCOUNTS PAYABLE

DEBIT	CREDIT
(A) 500	(B) 3,000

Note that in each of the T account entries, the debit part of the entry equals the credit part of the entry. This is an accounting rule that must always hold true. In the double entry system, a debit recorded in one account must be accompanied by an equal credit recorded in another account. Making debits and credits equal maintains the balance of the accounting equation and also provides a means of verifying the mathematical accuracy of recorded transactions. The balance of each account can also be computed by taking the difference between the debit and credit. For example in the cash account, there is $9,375 ($10,000 investment - $125 supplies - $500 paid on equipment account) cash balance remaining. Thus, cash has a debit balance. If a balance sheet was prepared at this time, cash of $9,375 would be reported.

CASH

DEBIT	CREDIT
(A) 10,000	(C) 125
	<u>(D) 500</u>
Total debits	625 Total credits

Balance of account

Total debits – Total credits

10,000 - 625

$9,375

TEMPORARY OWNER'S EQUITY ACCOUNTS

The owner's equity account is increased or decreased by the following temporary accounts: capital, drawing, revenue and expenses. It is increased by investment (capital account) by the owner or by the earning of revenue. It is decreased by withdrawals (drawing account) by the owner or by expenses of operating the business. Earlier we mentioned liabilities and owner's equity are on the right side of the equation; credit is on the right side of the equations. Therefore, liability accounts and owner's equity capital accounts are increased on the credit side. The opposite are true of the drawing and expense account, they are increased by debits and decreased by credit entries.

Balance Sheet Accounts

ASSETS		LIABILITIES	
Dr	Cr	Dr	Cr
+	-	-	+

OWNER'S EQUITY

CAPITAL		DRAWING	
Dr	Cr	Dr	Cr
-	+	+	-

Income Statement Accounts

EXPENSES		REVENUES	
Dr	Cr	Dr	Cr
+	-	-	+

It is possible to record all changes in owner's equity directly in the owner's capital account. Expenses and withdrawals reduce owner's equity so we could simply record an entry on the debit side of owner's equity to show the decrease. The same is true for investment by the owner or the earning of revenue, we could simply enter a credit entry directly into owner's equity to show the increase.

The procedure describe above is not practical. In most businesses, expenses and revenue transactions occur constantly, and the owner frequently withdraws assets for personal use. Recording these transactions in the owner's capital account clutters the account and does not provide a separate record for expense items, revenue items, and owner withdrawals. To determine the net income or net loss for an accounting period, the owner's capital account would have to be analyzed very carefully to determine the amount of revenue and expenses.

It is better accounting practice to have a separate ledger account for each type of expense, each type of revenue, and withdrawals. These accounts are subdivisions of the owner's capital account and are used to show the changes in owner's equity during the account period. When the period is over, these accounts will have served their purpose and their balances will be transferred to the owner's capital account. Hence, expense accounts, revenue accounts, and the owner's drawing account are said to be temporary owner's equity accounts. The temporary accounts will always be closed or reduced to zero at the end of the fiscal year or the accounting period. Specifically, the revenue and expense account will be closed to Income Summary. The Income Summary and the drawing account will be closed to capital. The closing process will be discussed in detail later in the class.

The following examples will use T accounts to illustrate the rules of debit and credit as applied to temporary owner's equity accounts.

(E) Paid first month's rent $400.

RENT EXPENSE

DEBIT	CREDIT
(E) 400	

CASH

DEBIT	CREDIT
(A) 10,000	(C) 125
	(D) 500
	(E) 400

(F) Received cash from customers for services $700.

CASH

DEBIT	CREDIT
(A) 10,000	(C) 125
(F) 700	(D) 500
	(E) 400

SERVICE REVENUE

DEBIT	CREDIT
	(F) 700

Accounting Terms Matching Quiz

a. Drawing b. Expenses c. Revenues d. Liabilities e. Chart of Accounts

f. Owner's Equity g. Assets h. Double Entry System i. Account j. Transaction

____ 1. Properties used in the operation of business.

____ 2. Claims by creditors to the property (assets) of a business.

____ 3. Owner's rights and claims to the property (assets) of a business.

____ 4. Increases to owner's equity resulting from business operations.

____ 5. A code of listing of all the accounts in the general ledger.

____ 6. Decreases to owner's equity resulting from owner's withdrawals.

____ 7. A financial event recorded in the books of a business.

____ 8. Every transaction is recorded in at least two places (accounts).

____ 9. Record for each asset, liability, revenue, and expense.

____10. The costs of operating a business and always decreases owner's equity.

HELPFUL HINTS

Debits are used to record:	Credits are used to record:
1. Increases in asset accounts	1. Increases in liability accounts
2. Increases in expense accounts	2. Increases in revenue accounts
3. Increases in the owner's drawing account	3. Increases in the owner's capital account
4. Decrease in liability accounts	4. Decreases in asset accounts
5. Decreases in revenue accounts	5. Decreases in expense accounts
6. Decreases in owner's equity accounts	6. Decreases in the owner's drawing account

Normal Balance of Accounts

An account usually has more increases than decreases. Hence, the normal balance side of an account is always the same as the increase side. Asset, expense and drawing accounts are increased on the debit side; therefore, they normally have debit balances. Liability, owner's capital, and revenue accounts are increased on the credit side; therefore, they normally have credit balances. Fill in the blanks in the following chart with asset, liability, owner's equity, debit or credit.

	Type of Account	Increase Side	Decrease Side	Normal Balance
Cash	Asset	Debit	Credit	Debit
Equipment				
Drawing				
Accounts Payable				
Service Revenue				
Rent Expense				
M. Hughes, Capital				
Taxes Payable				
Fees Earned				
Repair Expense				

Debit/Credit Exercise

Instructions: Select the appropriate Major Type of Account to Debit and Credit to record the transaction for the following transactions:

Assets Liabilities Capital Revenue Expense Draws

1. ABC mows a client's yard and receives a check from the customer for $50 for the services provided.

   Dr. ______________________ Cr. ________________________

2. ABC purchases $100 worth of office supplies for inventory and stores them in their storage room. The office supply store gives them an invoice that allows them to pay for them in 15 days (on account).

   Dr. ______________________ Cr. ________________________

3. ABC places an ad in the local newspaper receives the invoice from the supplier and writes a check for $25 to the newspaper.

   Dr. ______________________ Cr. ________________________

4. ABC purchases five mowers for $10,000 and finances them with a note from the local bank.

   Dr. ______________________ Cr. ________________________

5. ABC mowers another customer's yard and sends the customer a bill (invoice) for the service they performed. They allow their customer 10 days to pay them for this service (on account).

   Dr. ______________________ Cr. ________________________

6. The owner of ABC needs a little money to pay some personal bills and writes himself a check for $500.

   Dr. ______________________ Cr. ________________________

Recording Business Transactions in the Journal

Considering the number of transactions that occur on a daily basis, even with a small business, it is not reasonable to record business transactions in T accounts. T accounts are non-systematic and prove to be inadequate in handling a large number of transactions. As briefly discussed earlier, a journal entry would be recorded into the General Journal. Journalizing differs from recording transactions into T accounts only in form. The analysis of transactions and the accounts used are identical.

General Journal Page 1

	Date		Account Title	P.R.	Debit					Credit					
1	20X9 Oct	1	Cash	111	10	0	0	0	00						1
2			C. Michelle Hughes, Capital	311						10	0	0	0	00	2
3			Invested cash in the business												3

Note the following features of the above journal entry:

1. The date of the entry consists of the year (20X3), the month (October), and the day of the month (1).
2. The title of the account to be debited (Cash) is written on the first line at the extreme left margin of the Account Title column. The amount of the debit (10,000) is written in the Debit column on the same line. **Debits are always written before credits.** Dollar signs are not used in the journal.
3. The tile of the account to be credited (C. Michelle Hughes, Capital) is written on the second line of the Account Title column and indented one-fourth to one-half inch. The amount of the credit (10,000) is written in the Credit column on the same line.
4. The explanation of the entry (Invested in cash in the business) is written on the third line and indented beyond line 2. It is not necessary to explain all journal entries. If the transaction is routine it is usually not explained. If the transaction is a seldom occurring it is usually explained.

Although the journal shows much information it does not provide a complete summary of financial information about each account. Separate records are needed to show increases and decreases in each asset, liability, and each aspect of owner's equity. Such a record is called an account.

Journal Exercise

Record the following business transactions.

1. Ms. Hughes invested $10,000 to start her business.
2. Purchased office equipment for $3,000 on account.
3. Purchased office supplies for $125.
4. Paid $500 on equipment purchase.
5. Paid first month's rent $400.
6. Received cash from customers for services $700.

Hughes and Associates

Chart of Accounts

Assets (100-199)

111 Cash
112 Accounts Receivable
113 Office Supplies
116 Office Equipment
117 Office Equipment

Liabilities (200-299)

211 Accounts Payable

Owner's Equity (300-399)

311 C. Michelle Hughes, Capital
312 C. Michelle Hughes, Drawing

Revenue (400-499)

411 Service Revenue

Expenses (500-599)

511 Rent Expense
512 Repairs Expense

General Journal Page 1

	Date		Account Title	P.R.	Debit					Credit					
1	20X9 Oct	1	Cash	111	10	0	0	0	00						1
2			C. Michelle Hughes, Capital	311						10	0	0	0	00	2
3			Invested cash in the business												3
4															4
5															5
6															6
7															7
8															8
9															9
10															10
11															11
12															12
13															13
14															14
15															15
16															16
17															17
18															18
19															19
20															20
21															21

Posting Journal Entries to Ledger

An account is an individual record used to record and summarize information related to each of the accounting elements. An account can be thought of as a place of storage. As business transactions occur, financial information is recorded in the journal. Periodically, the journal entries are transferred to the accounts in the ledger. The ledger is a history of transactions by various asset, liability, and owner's equity accounts. The information is easily and quickly available for preparing financial statements and reports.

The three major parts of the standard form of account are the account title and number, the left (debit) side and the right (credit) side. Each account is given an appropriate title to identify it as an asset, liability, or owner's equity account. Accounts are also assigned numbers to aid in locating and recording. These numbers are also listed on the chart of accounts.

The four-column account form

Account   Account No.

DATE	ITEM	P.R.	DEBIT	CREDIT	BALANCE	
					DEBIT	CREDIT

The process of transferring debits and credits to the accounts from the journal is called posting. The four column account has a debit column, a credit column, a debit balance column and a credit balance column. The debit and credit columns are used to enter debits and credits from the journal. The balance columns are used to enter the balance of the accounts after each posting.

There are five steps to posting a debit and a credit part of a journal entry. The five steps are as follows:

1. Record the date of the journal entry in the Date column of the appropriate account.
2. Record the amount of the journal entry. Do not use dollar signs or decimal points.
3. Record the code 'GJ' (for General Journal) and page number (1) of the journal in the P.R. (Posting Reference) column of the account. The purpose of this step is to be able to trace the entry back to the journal.

4. Record the number of the account in the P.R. column of the journal. This step serves two purposes: (1) It indicates that the posting has been made. (2) It indicates the account to which posting has been made. After Steps 3 and 4 have been completed a cross reference will be provided between the journal and ledger.
5. Calculate the new balance of the account. A running balance is maintained for each account.

General Journal Page 1

	Date		Account Title	P.R.	Debit					Credit					
1	20X9 Oct	1	Cash	111	10	0	0	0	00						1
2			C. Michelle Hughes, Capital	311						10	0	0	0	00	2
3			Invested cash in the business												3

Account CASH Account No. 111

DATE		ITEM	P.R.	DEBIT					CREDIT					BALANCE									
														DEBIT					CREDIT				
20X9 Oct.	1	Owner investment	GJ1	10	0	0	0	00						10	0	0	0	00					

Account HUGHES CAPITAL Account No. 311

DATE		ITEM	P.R.	DEBIT					CREDIT					BALANCE									
														DEBIT					CREDIT				
20X9 Oct.	1	Owner investment	GJ1						10	0	0	0	00						10	0	0	0	00

Since transactions are recorded first in the journal (the book of original entry) then transferred to the ledger and the ledger is often referred to as the book of final entry.

Ledger Exercise

Post cash journal entries to ledger from journal exercise on page 29.

Account CASH Account No. 111

DATE		ITEM	P.R.	DEBIT					CREDIT					BALANCE									
														DEBIT					CREDIT				
20X9 Oct.	1	Owner investment	GJ1	10	0	0	0	00						10	0	0	0	00					

What is the cash balance? Is it a debit balance or credit balance?

The Trial Balance

After the ledger is fully posted, the next step of the accounting cycle is to prepare a trial balance to check the equality of debits and credits. As discussed earlier, the total of all accounts with debit balances must equal the total of all accounts with credit balances in a double entry accounting system. The trial balance lists every open general ledger account by account number and provides the separate debit and credit columns for entering account balances. Typically, trial balances are prepared at the end of the month, however, they may be prepared at any time. It should be stressed that a trial balance shows only that total debits and credits equal. A trial balance is not a formal financial statement or report. However, information to prepare formal statements can come directly from the trial balance.

Hughes and Associates
Trial Balance
October 31, 20X9

	Account Title	Debit	Credit
100	Cash	9,675.00	
113	Office Supplies	125.00	
116	Office Equipment	3,000.00	
211	Accounts Payable		2,500.00
311	C. Michelle Hughes, Capital		10,000.00
312	C. Michelle Hughes, Drawing	0	
411	Service Revenue		700.00
511	Rent Expense	400.00	
	Totals	13,200.00	13,200.00

Adjusting Entries

Much of the accounting process involves recording the day-to-day business transactions. There are some transactions, however, that are not recorded by routine accounting entries. This is not due to an error but is a result of changes in the nature of certain accounts brought about by the passage of time. For example, the office supplies account shows all of the purchases of office supplies used by the business. Office supplies are constantly used in the day-to-day operation of most businesses. It would be impractical to attempt to make a journal entry each time office supplies were used. Consequently, no regular journal entries are made to record the value of supplies used on a daily basis. So as time passes the balance showing in the office supplies account becomes inaccurate and must be adjusted. This type of adjustment is known as an adjusting entry and is made at the end of an accounting period to bring certain accounts up to date. Adjusting entries are called internal entries because they do not involve parties outside of the business. An adjusting entry always involves an income statement account (revenue or expense) and a balance sheet account (asset or liability).

General Journal Page 1

	Date		Account Title	P.R.	Debit	Credit	
1	20X9 Oct	30	Office supplies Expense	513	2 5 00		1
2			Office Supplies	113		2 5 00	2
3			Office Supplies Used				3

Account OFFICE SUPPLIES EXPENSE Account No. 513

DATE		ITEM	P.R.	DEBIT	CREDIT	BALANCE	
						DEBIT	CREDIT
20X9 Oct.	30	Office Supplies Used	GJ1	2 5 00		2 5 00	

Account OFFICE SUPPLIES Account No. 113

DATE		ITEM	P.R.	DEBIT	CREDIT	BALANCE	
						DEBIT	CREDIT
20X9 Oct.	3	Bought office supplies	GJ1	1 2 5 00		1 2 5 00	
	30	Office Supplies Used	GJ1		2 5 00	1 0 0 00	

Adjusted Trial Balance

An adjusted trial balance is performed after journaling and posting all the adjusting entries.

	Hughes and Associates Adjusted Trial Balance October 31, 20X9		
	Account Title	**Debit**	**Credit**
100	Cash	9,675.00	
113	Office Supplies	100.00	
116	Office Equipment	3,000.00	
211	Accounts Payable		2,500.00
311	C. Michelle Hughes, Capital		10,000.00
312	C. Michelle Hughes, Drawing	0	
411	Service Revenue		700.00
511	Rent Expense	400.00	
513	Office Supplies Expense	25.00	
	Totals	13,200.00	13,200.00

Financial Statements

Summaries of financial transactions are called financial statements. Financial statements are prepared on a regular basis at the end of the accounting period. An accounting period is typically one year; however, it can be any length of time for which accounting records are maintained. Usually, the minimum period is one month.

The four basic financial statements are the 1) income statement or statement of earnings 2) the statement of changes in stockholders equity or statement of retained earnings 3) the balance sheet or statement of financial position and 4) the statement of cash flows. The statements are normally prepared in that exact order because each statement relies on information from the prior statement with the exception of the income statement which is prepared first. Also, notes are at the end of each particular financial statement to disclose relevant information that isn't apparent examining the figures on the statements alone. All financial statements should be identified by the name of the business, the title of the statement and date or period of time.

Income Statement

The income statement shows a summary of a business's revenue and expenses for a specific period of time. When revenue exceeds expenses, there is net income. If expenses exceed revenue, there is a net loss. The income statement is prepared first because the net income or loss is used on the statement of owner's equity. Net income increases owner's equity and net loss decreases owner's equity.

Hughes and Associates **Income Statement** **For the Month Ended October 31, 20X9**		
Revenue		**$700.00**
Expenses:		
Rent Expense	**400.00**	
Office Supplies Expense	**25.00**	
Total Expense		**425.00**
Net Income (Loss)		**$275.00**

Observe the four features about the income statement:

1. The heading consists of three lines answering who, what, and when.
   a. Who is the firm? (Not the owner)
   b. What type of statement is it?
   c. When is the accounting period?
2. Only revenue and expenses and gains and losses are placed on the income statement.
3. Net income/loss is the difference between total revenue and total expenses.
4. Expenses are listed in order of size, beginning with the largest; this is a common arrangement but varies among businesses. Miscellaneous expenses are usually last regardless of the amount.

Earnings statement, operating statement, statement of operations, profit and loss statement, and P&L statement are other terms used to describe the income statement. The income statement may be presented using a single-step or multiple-step format. The single step format is shown above by placing revenue and expense accounts in separate groups then total expenses are deducted from total revenues to determine the net income or loss. The multiple-step format uses the same accounts and balances but separates the cost of services provided from operating expenses and also includes a category for other types of income and expense. Also, the appraiser should look for long term assets that are expensed under Section 179 on the income statement.

Statement of Owner's Equity or Retained Earnings

The statement of owner's equity is a summary of the changes that have taken place in owner's equity during the accounting period. As previously stated, four types of transactions affect owner's equity: (1) revenue, (2) owner investments, which increase it, (3) expenses, and (4) owner withdrawals, which decrease it.

All of these items are shown on the statement of owner's equity, except that two of them (revenue and expenses) are combined into the net income or net loss figure.

Hughes and Associates Statement of Owner's Equity For Month Ended October 31, 20X9		
C. Michelle Hughes, Capital, October 1, 20X9		**$10,000.00**
Net income for the month	**$275.00**	
Less withdrawals	**0**	
Increase in capital		**275.00**
C. Michelle Hughes, Capital, October 31, 20X9		**$10,275.00**

Observe the features about the owner's equity statement:

1. The heading is similar to the income statement, both represent a specific time period
2. The company is in its first month of operation, the beginning capital balance is the initial investment of $10,000. Next month's beginning balance will be the ending balance of this month's statement.
3. The net income figure is obtained from the income statement. Hence, the reason to derive the income statement first.
4. The net increase in capital is the difference between net income and withdrawals for the period. If the company experienced a net loss or if withdrawals exceed net income for the period, there would have been a decrease in capital.

The statement of owner's equity is sometimes called the capital statement or statement of retained earnings if the company is not closely held. It is prepared second, due to the fact, the amount of owner's equity at end of the period must be reported on the balance sheet. Hence, the statement of owner's equity is often viewed as the connecting link between the income statement and the balance sheet.

Balance Sheet

The balance sheet shows a firm's assets, liabilities, and owner's equity at a specific point in time. It is an expanded statement of the accounting equation showing that A = L + OE. An example of a balance sheet is given on the following page. Note the following points about the balance sheet:

1. The three-line heading differs on the 'when' line. A balance sheet is always as of a specific date.
2. The amount used for capital is taken directly from the statement of owner's equity. This makes it necessary to derive the statement of owner's equity before the balance sheet.
3. The final, doubled ruled totals show balance or equality. Remember a balance sheet shows A = L + OE.
4. This form of a balance sheet, with the liabilities and owner's equity sections presented directly below the asset section, is called a report form. Other forms may be presented, such as the account form. It is called the account form because it resembles the basic format of the accounting equation with assets on the left side and liabilities and owner's equity on the right side. However, each form illustrates the accounting equation, A = L + OE.

Hughes and Associates
Balance Sheet
October 31, 20X9

Assets		
Cash	**$9,675.00**	
Office Supplies	**100.00**	
Equipment	**3,000.00**	
Total Assets		**$12,775.00**
Liabilities		
Accounts Payable		**$2,500.00**
Owner's Equity		
C. Michelle Hughes, Capital		**10,275.00**
Total Liabilities and Owner's Equity		**$12,775.00**

The asset section of the balance sheet normally presents assets in the order that they will be converted into cash or used in operations. Cash is presented first, followed by receivables, supplies, prepaid insurance, and other assets. The assets of a more permanent nature are shown next, such as land, buildings, and equipment. When there are two or more liabilities, each should be listed and then totaled.

An important thing to remember is how the balance sheet is headed. It is always as of a specific point in time. Many textbooks and articles have referred to the balance sheet as a snapshot of a business's financial position. Keep in mind that a snapshot is only good at that exact moment in time.

Other terms used to describe the balance sheet are statement of financial position and position statement.

The Statement of Cash Flows

The statement of cash flows discloses the sources and uses of cash during the reporting period. The sources and uses of cash for the period are reported by 1) operating activities 2) investing activities and 3) financing activities. Because under the accrual method of accounting revenue is recorded when earned and not collected and expenses accrued when incurred and not actually paid net income is not an accurate indicator of how much cash the entity collected during the period and how much cash it spent during the same period. The statement of cash flows shows where cash balances are generated from whether sales (operating activities), debt or stock issuance (finance activities) or equipment or other asset purchases (investing activities). The total of the net cash flow activities should equal the cash reported on the balance sheet. The preparation of the cash flow statement will not be discussed.

Notes to the Financial Statements

As briefly discussed earlier, the notes to the financial statements are literal notes included at the end of each financial statement that disclose relevant information about the particular financial statement that is not apparent in the financial statement itself. Examples include:

- The method of depreciation used at the end of the income statement (straight-line, declining balance, sum of the years' digit, etc.)

- The method of inventory costing used (LIFO, FIFO, weighted average, etc.) at the end of the income statement and balance sheet

Business events occurring after end of the accounting period and contingencies existing during the accounting period for which no monetary amounts are or can be included in any account in the financial statements…for example if financial statements are as of 12/31/xxxx….

- lawsuits filed before or after 12/31/xxxx

- business losses after 12/31/xxxx but before preparation of financial statements

- casualty losses such as hurricane, fire or flooding damage or even theft occurring after fiscal year end (12/31/xxxx) but before preparation of financial statements

Closing Entries

Finally, we will discuss a final type of entry that deals with revenue and expense accounts as well as with the owner's drawing account. As you recall from previous discussion, revenue accounts, expense accounts, and the owner's drawing accounts are called temporary or nominal accounts. They are used to show changes in owner's equity during a single accounting period. When an accounting period is over, the temporary accounts have served their purpose for that period. Therefore, their balances are summarized and transferred to the owner's capital account. Assets, liabilities and owner's capital account, in contrast, are called real or permanent accounts, the ending balance in one period is always the starting balance in the subsequent accounting period.

The process of transferring the balances of the temporary accounts is called the closing process. Entries necessary to accomplish the closing process are called closing entries.

The closing process has two objectives:

1. To reduce the balance of temporary owner's equity accounts to zero, making the accounts ready for the next accounting period. Otherwise, amounts for the next accounting period would be added to amounts left from past accounting periods. This would be a violation of the matching principle.

2. To update the balance of the owner's capital account.

An account called Income Summary is used in the closing process. The income summary account is a 'clearinghouse' account used to summarize the balances in the revenue and expense accounts. Use of the income summary account avoids the unnecessary detail of closing the balances of each revenue account and each expense account directly into the owner's capital account. The income summary account is used only at the end of the accounting period and is opened and closed during the closing process.

The closing process consists of four steps:

1. Close the income statement accounts with credit balances (revenue accounts) to the Income Summary account.

General Journal Page 2

	Date		Account Title	P.R.	Debit	Credit	
1	20X9 Oct	30	Revenue	411	7 0 0 00		1
2			Income Summary	600		7 0 0 00	2
3			Close credit-balance accounts				3

Account REVENUE Account No. 411

DATE		ITEM	P.R.	DEBIT	CREDIT	BALANCE	
						DEBIT	CREDIT
20X9 Oct.	6	Service Revenue	GJ1		7 0 0 00		7 0 0 00
	30	Closing Entry	GJ2	7 0 0 00			0 00

Account INCOME SUMMARY Account No. 600

DATE		ITEM	P.R.	DEBIT	CREDIT	BALANCE	
						DEBIT	CREDIT
20X9 Oct.	30	Credit balance accounts	GJ2		7 0 0 00		7 0 0 00

2. Close the income statements with debit balances (expense accounts) to the Income Summary account. After the revenue and expense account is closed, the income summary account balance equals the company's net income or loss for the period.

General Journal Page 2

	Date		Account Title	P.R.	Debit	Credit	
4		30	Income Summary	600	4 2 5 00		4
5			Rent Expense	511		4 0 0 00	5
6			Office Supplies Expense	513		2 5 00	6
7			Close debit-balance accounts				7

Account RENT EXPENSE Account No. 511

DATE		ITEM	P.R.	DEBIT	CREDIT	BALANCE DEBIT	BALANCE CREDIT
20X9 Oct.	5	Rent Expense	GJ1	4 0 0 00		4 0 0 00	
	30	Closing Entry	GJ2		4 0 0 00		0 00

Account OFFICE SUPPLIES EXPENSE Account No. 513

DATE		ITEM	P.R.	DEBIT	CREDIT	BALANCE DEBIT	BALANCE CREDIT
20X9 Oct.	30	Office Supplies Expense	GJ1	2 5 00		2 5 00	
	30	Closing Entry	GJ2		2 5 00		0 00

Account INCOME SUMMARY Account No. 600

DATE		ITEM	P.R.	DEBIT	CREDIT	BALANCE DEBIT	BALANCE CREDIT
20X9 Oct.	30	Credit balance accounts	GJ2		7 0 0 00		7 0 0 00
		Debit balance accounts	GJ2	4 2 5 00			2 7 5 00

3. Close the balance of the Income Summary account to the owner's capital account.

General Journal Page 2

	Date		Account Title	P.R.	Debit					Credit					
7		30	Income Summary	600		2	7	5	00						7
8			C. Michelle Hughes, Capital	311							2	7	5	00	8
9			Close income summary												9

Account INCOME SUMMARY Account No. 600

DATE		ITEM	P.R.	DEBIT					CREDIT					BALANCE									
														DEBIT					CREDIT				
20X9 Oct.	30	Credit balance accounts	GJ2							7	0	0	00							7	0	0	00
	30	Debit balance accounts	GJ2		4	2	5	00												2	7	5	00
	30	Transfer to capital	GJ2		2	7	5	00														0	00

Account HUGHES CAPITAL Account No. 311

DATE		ITEM	P.R.	DEBIT					CREDIT					BALANCE									
														DEBIT					CREDIT				
20X9 Oct.	1	Owner investment	GJ1						10	0	0	0	00						10	0	0	0	00
	30	Net income	GJ2							2	7	5	00						10	2	7	5	00

4. Close the balance of the owner's drawing account directly to the owner's capital account. *(hypothetical situation: no drawing entry actually occurred in this example)*

General Journal Page 2

	Date		Account Title	P.R.	Debit	Credit	
10		30	C. Michelle Hughes, Capital	311	5 0 00		10
11			C. Michelle Hughes, Drawing			5 0 00	11
12			Close drawing account				12

Account HUGHES CAPITAL Account No. 311

DATE		ITEM	P.R.	DEBIT	CREDIT	BALANCE	
						DEBIT	CREDIT
20X9 Oct.	1	Owner investment	GJ1		10 0 0 0 00		10 0 0 0 00
	30	Net income	GJ2		2 7 5 00		10 2 7 5 00
	30	Close drawing account	GJ2	5 0 00			2 2 5 00

Account HUGHES DRAWING Account No. 312

DATE		ITEM	P.R.	DEBIT	CREDIT	BALANCE	
						DEBIT	CREDIT
20X9 Oct.	15	Owner withdrawal	GJ1	5 0 00		5 0 00	
	30	Close entry	GJ2		5 0 00		5 0 00

Post-Closing Trial Balance

After the closing entries are journalized and posted, only permanent, balance sheet accounts remain open. A post-closing trial balance is prepared to check the clerical accuracy of the closing entries and to prove that the accounting equation is in balance before the next accounting period begins. *(Does not include drawing entry)*

	Hughes and Associates Post-Closing Trial Balance October 31, 20X9		
	Account Title	**Debit**	**Credit**
100	Cash	9,675.00	
113	Office Supplies	100.00	
116	Office Equipment	3,000.00	
211	Accounts Payable		2,500.00
311	C. Michelle Hughes, Capital		10,275.00
	Totals	$12,775	$12,775

Review

Circle the best answer.

1. The first step in the accounting cycle is to:
   a. Record transactions in the journal
   b. Take a trial balance
   c. Analyze transactions from source documents
   d. Post to the ledger

2. Which of the following is not found in a journal?
   a. A date column
   b. An account for each asset, liability, revenue, and expense of the company
   c. An account title column
   d. Two money columns

3. If J. Colter paid rent for one month on his office, the transaction would be recorded as:
   a. A debit to Rent Expense and a credit to Cash
   b. A debit to Cash and a credit to Rent Expense
   c. A debit to J. Colter, Capital and a credit to Cash
   d. A debit to Cash and a credit to J. Colter, Capital

4. Which of the following are advantages of using a journal?
   a. The journal provides a chronological record of the transaction
   b. The journal provides a place to record explanations
   c. The journal decreases the possibility of errors
   d. All of the above

5. The second step in the accounting cycle is to:
   a. Journalize the transactions
   b. Post from the journal to the ledger
   c. Take a trial balance
   d. Foot the accounts

6. Which is the correct sequence for the preparation of financial statements?

   a. Owner's Equity, Balance Sheet, Cash Flow Statement, Income Statement
   b. Income Statement, Cash Flow Statement, Balance Sheet, Owner's Equity
   c. Income Statement, Owner's Equity, Balance Sheet, Cash Flow Statement
   d. Cash Flow Statements, Owner's Equity, Balance Sheet, Income Statement

Fill in the blanks with the correct word(s)

7. ________________ is the process of recording transactions in the journal.

8. The journal in which any business transaction can be recorded is called the ________________ ________________.

9. If John Smith invested $50,000 to begin a new business, the cash account would be debited and the ________________ account would be credited.

10. Transferring information from the journal to the ledger is called ________________.

11. The order of accounts in the ledger usually follows the order of accounts on the financial statements, beginning with the ________________ accounts.

12. The third step in the accounting cycle is to ________________ from the journal to the ledger.

13. When journalizing transactions in the general journal, the name of the account being credited is written on the line below the debit entry and is ________________ one-fourth to one-half inch.

14. If John Smith purchased office supplies for cash, the ________________ account would be debited and the ________________ account would be credited.

15. Accounts Payable is a _______________ account.

16. The journal provides a(n) ________________ record of transactions; it is a diary of the company's transactions.

17. Adjusting entries are ________________ caused by errors but is a result of ________________ in the nature of certain accounts due to the passage of time.

18. Revenue and expense accounts and the owner's drawing account are called ________________ ________________.

19. One purpose of the closing process is to reduce the balances of the temporary accounts to ________________.

20. The income summary account is closed to the owner's ________________ account.

21. The owner's drawing account is closed to the _______________ account.

22. A revenue account is closed by _______________ the account for the amount of its balance.

23. An expense account is closed by _______________ the account for the amount of its balance.

24. After closing entries are posted, all _______________ accounts will have a balance of zero.

25. A fiscal period 12 months in length is called a(n) _______________ _______________.

26. When a fiscal year ends at the lowest point in business activity, it is called a(n) _______________.

27. ___________________ are at the end of each particular financial statement to disclose relevant information that isn't apparent examining the figures on the statements alone.

28. All ____________________ ___________________ should be identified by the name of the business, the title of the statement and date or period of time.

Practice Exercise

a. Record the following transactions in a general journal.

October	1	J. Jones invested $12,000 in cash to start a business, Jones Company
	2	Paid rent for $450
	4	Purchased supplies for cash, $475
	8	Purchased equipment on credit, $2,900.
	10	Performed services and received $1,200 cash.
	11	Purchased supplies on account, $300.
	15	Performed services and received $500 cash.
	21	Withdrew cash for personal use, $800.
	27	Paid salaries for the month, $800.
	31	Paid $200 on the equipment purchased Oct. 8.

b. Prepare a trial balance.

c. Prepare an income statement.

d. Prepare a statement of owner's equity.

e. Prepare a balance sheet.

f. Prepare journal entries to close the revenue and expense accounts.

GENERAL JOURNAL

Page 1

	Date		Account Title	P.R.	Debit	Credit	
i							1
2							2
3							3
4							4
5							5
6							6
7							7
8							8
9							9
10							10
11							11
12							12
13							13
14							14
15							1S
16							16
17							17
18							18
19							19
20							20
21							21
22							22
23							23
24							24
25							25
26							26
27							27
28							28
29							29
30							30
31							31
32							32

JONES COMPANY
T - ACCOUNTS

CASH	SUPPLIES	EQUIPMENT	ACCTS. PAYABLE

NOTE PAYABLE	OWNERS CAPITAL	OWNERS DRAWING	SERVICE REVENUE

SALARY EXPENSE	RENT EXPENSE

JONES COMPANY
TRIAL BALANCE
AS OF 10/31/09

ACCOUNT	DESCRIPTION	DEBIT	CREDIT
1000	Cash	$	$
1100	Supplies	$	$
1200	Equipment	$	$
2000	Accounts Payable	$	$
2100	Note Payable	$	$
3000	Owner's Capital	$	$
3100	Owner's Drawing	$	$
4000	Service Revenue	$	$
5000	Salary Expense	$	$
5100	Rent Expense	$	$
	TOTALS	$	$

JONES COMPANY
INCOME STATEMENT
AS OF 10/31/09

Service Revenue	$	
Misc. Revenue	$	
Gain on Sale of Assets	$	
Total Revenue	$	$
Salary Expense	$ -	
Rent Expense	$	
Loss on Sale of Assets	$	
Total Expenses	$	$
Net Income		$

JONES COMPANY
STATEMENT OF OWNER'S EQUITY
AS OF 10/31/09

Jones, Capital 10/01/09		$
Net Income for month	$	
Less: Drawing/withdrawals	$	
Decrease/Increase in Capital		$
Jones, Capital 10/31/09		$

JONES COMPANY
BALANCE SHEET
AS OF 10/31/09

Assets:		
Cash	$ ______	
Supplies	$ ______	
Equipment	$ ______	
Total Assets	$ ______	$ ______
Liabilities:		
Accounts Payable	$ ______	
Note Payable	$ ______	
Total Liabilities	$ ______	$ ______
Owner's Equity:		
Jones,capital	$ ______	$ ______

JONES COMPANY
CLOSING ENTRIES
AS OF 10/31/09

		Debit	Credit
10/31	Income Summary	______	
	Rent Expense		______
	Salary Expense		______
	(to close expense accounts)		
10/31	Service Revenue	______	
	Income Summary		______
	(to close revenue account)		

Inventory Cost Methods

As it pertains to the return of inventory in Georgia, we learned in Course III that inventory should be reported at 100% cost on January 1. Cost should include, but not be limited to, freight in, overhead or burden, federal, state, or local taxes, or any other charges imposed upon the item that makes it more valuable to the owner. Costs will be arrived at by converting anything other than current cost back to cost. In other words, cost equals the value exchanged at the time of acquisition. We also learned that "LIFO" is not acceptable as a method of assigning cost to inventory. We will continue the discussion of inventory and the various methods of assigning cost.
.
Inventory is assets acquired by the business for either:

1. Future sale in the ordinary course of business.
2. Use in the production of goods or services for future sale.

Inventory is classified as a current asset on the balance sheet following receivables. The details of the cost method used may be disclosed in parenthesis on the balance sheet or in a footnote to the balance sheet or income statement. It is expected to be converted into cash within a one-year period. Items included in inventories are those items to which the business has legal title.

Hughes and Associates **Balance Sheet** **October 31, 20X9**		
Assets		
Current Assets:		
Cash		**$19,400.00**
Accounts Receivable	**40,000.00**	
Less allowance for doubtful accounts	**(3,000.00)**	**37,000.00**
Merchandise inventory-at lower of cost (first-in, first-out method) or market		**40,000.00**
		96,400.00

Management is responsible for determining and maintaining the proper level of goods in inventory. If inventory contains too few items, sales may be missed. If inventory contains too many items, the business pays unnecessary amounts to warehouse to secure and insure the items and the company's cash flow becomes one sided—cash flows out to purchase inventory but cash does not flow in from sales.

Merchandising companies normally classify all goods available for sale in one inventory category. Manufacturing companies generally use three inventory categories: finished products, work in process, and raw materials.

Therefore, the classes of Inventories include:

- Goods for sale
- Finished goods of a manufacturer
- Raw Materials
- Work in Process

All inventory owned by a business should be included on the personal property tax return. As stated above, for an item to be considered inventory the business must have legal title. Goods in transit inventory title passes either at the point of shipping or at the point of destination. The term free or freight on board (F.O.B.) indicates the point in the supply chain where the seller relinquishes ownership and the buyer accepts ownership of products purchased in a specific transaction. The personal property appraiser can obtain freight terms and shipping and receiving documents to verify this information.

- F.O.B. Destination means the seller is responsible for transportation costs. Therefore, ownership or title passes when the goods arrive at their destination point.

- F.O.B. Shipping Point means the buyer is responsible for transportation costs. Title passes to the buyer when the inventory is loaded on the truck.

Consigned Goods is merchandise that has been placed with a consignee or agent for sale. This merchandise belongs to the consignor and should appear on the consignor's inventory.

Periodic and Perpetual Inventory Systems

The inventory record keeping procedures used by a business is called an inventory system. If a business uses a periodic method the inventory quantities and values are determined only periodically, usually when financial statements are prepared.

Businesses that use the periodic system begin the process of determining the value of inventory by taking a physical count. This is a time-consuming process and actually involves an actual hand count of what is on the shelves and in the stockroom. Some businesses actually close down to take inventory.

Not so long ago it could have been said that the periodic inventory system was used by businesses that sell a relatively high volume of low-cost items, such as groceries, hardware, drugs, and clothing. This statement is less and less true as the cost of computers and software continue to become more and more cost effective. Many businesses have perpetuated their inventory systems.

While the periodic inventory system is based around taking and valuing physical inventory at the end of an accounting period, a perpetual (occurring repeatedly) inventory system continuously updates inventory quantities and values. When merchandise is purchased, the merchandise inventory is increased, when it is sold the amount is decreased. Thus, the balance of the inventory account always reflects the value of the inventory on hand.

Periodic Method

	Date		Account Title	P.R.	Debit	Credit	
1	20X9 Oct	30	Accounts Receivable – M. Watts	101	5 0 0 00		1
2			Sales	400		5 0 0 00	2
3			Sold two lamps				3

Perpetual Method

	Date		Account Title	P.R.	Debit	Credit	
1	20X9 Oct	30	Accounts Receivable – M. Watts	101	5 0 0 00		1
2			Sales	400		5 0 0 00	2
3			Sold two lamps				3
4		30	Cost of Goods Sold	500	1 0 0 00		4
5			Inventory-Lamps	105		1 0 0 00	5
6			Cost of lamps-$50 each				6

Methods of Assigning Costs to Inventory

After the quantities of inventories have been determined, a dollar amount must be assigned to the goods remaining on hand. In this section we will discuss four methods of assigning a dollar value (based on cost) to inventory. The four methods are Specific Identification, First-In, First-Out (FIFO), Last-In, First-Out (LIFO), and the Weighted Average Method.

To illustrate the above methods, we will value 540 units that remain in inventory at the end of the accounting period. The following schedule of inventory will be used:

Beginning Inventory	400 units	@ $4.00 =	$ 1,600
First purchase, Jun. 7	700 units	@ $4.25 =	2,975
Second purchase, Jun. 15	800 units	@ $4.30 =	3,440
Third purchase, Jun. 21	600 units	@ $4.30 =	2,580
Fourth purchase, Jun. 26	500 units	@ $4.40 =	2,200
Total available for sale	3,000 units		$12,795
Inventory count on June 30	540 units		

Specific Identification Method

If the 540 units in the ending inventory can be identified as having come from specific purchases, they may be assigned a cost based on the price of those purchases. To illustrate, assume that on June 30 the inventory consisted of 25 units from the beginning inventory, 100 units from the June 15 purchase, 175 units from the June 21 purchase, and 240 units from the June 26 purchase. Using the specific identification method, the June 30 ending inventory is valued as follows:

Value by specific identification method

25	units @	4.00	=	$100.00
100	units @	4.30	=	$430.00
175	units @	4.30	=	$752.50
240	units @	4.40	=	$1,056.00
540	units			$2,338.50

The specific identification method is usually used for high-priced, low sales-volume items, such as automobiles, machinery, and high fashion items. Even though this method gives an exact inventory, it is seldom used because it is too laborious and time consuming to justify. The three other methods that will be discussed deal with a flow of goods and their costs in and out of inventory normally used by companies that sell a large number of inexpensive items.

First-In, First-Out (FIFO) Method

The first-in, first-out method is an acceptable measure of costing inventory. Inventory value is calculated on the assumption that the first goods purchased (first-in) are the first goods sold (first-out). Think about perishable items sold in a super market. Goods remaining at the end of the period are assumed to be made up of the most recent purchases – the latest costs. The FIFO method assumes that goods are sold in the order they were bought. Prices most recently paid are a better indication of replacement cost than are prices from months, even years earlier. To illustrate we will use the same 540 units as above.

The latest purchase of inventory consists of 500 units and $4.40 each. These 500 are assumed to be on hand since they were the last purchased. However, there are 540 units left in ending inventory. This means that 40 units were left over from the next to the last purchase which was bought at a cost of $4.30 per unit. Using the FIFO method of valuation, the June 30 ending inventory is valued as follows:

First-In, First-Out Method

40	units @	4.30	=	$172.00
500	units @	4.40	=	$2,200.00
540	units			$2,372.00

The FIFO method is usually consistent with the actual flow of goods because most goods are sold in the order that they were purchased. This is particularly true of perishable goods or goods in which styles frequently change.

Practice Exercise

The following transactions occurred October – December:

October 1	Beginning Inventory – 400 units	$4.00
October 15	Purchase 100 units	$5.00
November 15	Purchase 20 units	$6.00
December 15	Purchase 80 units	$5.50
December 20	Sell 120 units	$8.00
December 28	Sell 200 units	$7.00

Calculate the ending inventory and cost of goods sold on December 31 using the FIFO system.

Last-In, First-Out (LIFO) Method

The last-in, first-out method of costing inventory is less acceptable because it assumes that the last goods bought (last-in) are the first goods sold (first-out). Goods on hand at the end of the accounting period are assumed to be among the first goods purchased for sell. The LIFO method assumes that goods are sold in the reverse order in which they were bought. Taxpayers may use LIFO for income tax purposes, but it does not reflect inventory value for tax purposes. To illustrate we will use the same 540 units as above.

The earliest cost was the beginning inventory of 400 units at $4.00. However, as before a cost must be assigned to 540 units. We refer to the next earliest cost, $4.25 per unit, (the first purchase of June 7) for the needed 140 units. Using the LIFO method of valuation, the June 30 ending inventory is valued as follows:

Last-In, First-Out Method

400	units @	4.00	=	$1,600.00
140	units @	4.25	=	$595.00
540	units			$2,195.00

Since the LIFO method assumes that the last goods purchased are the first ones sold, it does not match the actual flow of goods for most businesses. LIFO is a method of assigning a cost to inventory so the actual flow does not have to be in the order of last-in, first-out. Any business can use the LIFO method.

Practice Exercise

The following transactions occurred October – December:

October 1	Beginning Inventory – 400 units	$4.00
October 15	Purchase 100 units	$5.00
November 15	Purchase 20 units	$6.00
December 15	Purchase 80 units	$5.50
December 20	Sell 120 units	$8.00
December 28	Sell 200 units	$7.00

Calculate the ending inventory and cost of goods sold on December 31 using the LIFO system.

The Weighted Average Method

The weighted average method is based on the assumption that costs should be assigned to inventory based on the *average* cost of each unit. The average used in this method is arrived at by dividing the total cost of units available for sale by the total number of units available for sale. This results in a 'weighted' average rather than a simple average. The value of the inventory is then calculated by multiplying the average cost by the number of units left in inventory. In other words, the weighted average provides for distribution of inventory costs throughout the year. The weighted average method is not an acceptable measure of inventory value when compared to the FIFO method.

Once again we will value the remaining 540 units in period ending inventory. Using the Weighted average method of valuation, the June 30 ending inventory is valued as follows:

$12,795 / 3,000 units = $4.27 average cost per unit

Then multiple the numbers of units in the ending inventory (540) by the average cost per unit (4.27) to get the cost of the ending inventory:

540 units X $4.27 = $2,306

The weighted average method is logical when assigning costs to units that become mixed together, making separate identification difficult or impossible. Grain, gasoline, and coal are examples of products that could logically measure by the use of this method. However, such products can be measured by other methods also.

Practice Exercise

The following transactions occurred October – December:

October 1	Beginning Inventory – 400 units	$4.00
October 15	Purchase 100 units	$5.00
November 15	Purchase 20 units	$6.00
December 15	Purchase 80 units	$5.50
December 20	Sell 120 units	$8.00
December 28	Sell 200 units	$7.00

Calculate the ending inventory and cost of goods sold on December 31 using the weighted average system.

Lower of Cost or Market Rule

Cost is the primary basis for valuing inventories. As an alternative to using one of the four cost methods we have discussed is to compare the cost of the merchandise on hand with the replacement cost of the merchandise and choose the lower of the two figures. Oftentimes, items decrease in value because they become less expensive to purchase. In other words, the market value drops. Inventory that has suffered loss in book value will be carried on the owner's books under a term referred to as lower of cost or market (LCM) or when inventory is not salable at normal sales prices. Cost in the rule means the amount calculated using any of the four methods discussed so far. Market means the price to replace the inventory on the date of the inventory bought in typical quantities through the usual means. It is the typical price that we would pay today. A firm must use the LCM rule when there is a change in the value of the inventory that is substantial and is expected to be permanent. It is further assumed that a change in the replacement cost of an item is accompanied by a change in the selling price.

Suppose a retailer purchases 500 items of inventory A for $100 each. After the retailer sells 100 items of inventory A, the manufacturer decreases inventory A's price to $75 for all buyers. Applying the lower of cost or market rule means the value of the remaining 400 inventory A equals $30,000 (400 x $75) rather than $40,000 (400 x $100). The retailer would record a loss on Inventory A by debiting a loss on inventory write-down account and by crediting inventory.

The LCM rule can be applied to the entire inventory, to product groups, or item-by-item. The following example shows two of the three possibilities: (1) item by item, and (2) entire inventory.

Item	Cost	Market	LCM	
1	$50	$60	$50	$50 is lower than $60
2	40	50	40	
3	60	50	50	$50 is lower than $60
4	75	60	60	
5	45	60	45	
6	70	70	70	Either value is used
Totals	$340	$350	315	Lower item by item

Lower Entire Inventory

On each line of the tabulation, the cost was compared to the market price and the lower amount was entered into the LCM column. The cost of item 1 was lower than its market price, so $50 was extended to the LCM column. If the LCM were based on the entire inventory, then the total cost of $340 would be compared to the total market price of $350; the lower figure would be reported on financial statements. You will always get a lower ending inventory value using LCM when you apply the rule item by item.

Estimating Inventories

It may be necessary for the personal property appraiser to estimate the amount of inventory when inventory records are not maintained and it is impractical to take a physical inventory. For example, a big box retailer has made a return and the numbers do not seem plausible but taking a physical inventory may be too costly or time consuming for the county. In such cases, the inventory cost can be estimated by using (1) the retail method or (2) the gross profit method. These methods are not foolproof, since they rely upon historical trends, but they should give you a reasonably accurate number, as long as no unusual transactions occurred during the period that might alter the ending inventory.

The Gross Profit Method

By slightly modifying the cost of goods sold formula, you can estimate an ending inventory value by the Gross Profit Method. Under this method, the expected gross profit rate (gross profit to net sales) for the period is used. The ending inventory can be computed by preparing a partial income statement or cost of goods sold equation.

Gross Profit Estimation

Given: Gross Profit rate has been running 45 percent of sales.

Sales	$600,000
Beginning Inventory	25,000
Purchases	350,000
Cost of goods available for sale	375,000
Less: Ending Inventory	
Cost of Goods Sold	
Gross Profit	

1)

Gross Profit Rate	X	Sales	=	Gross Profit
45%	X	$600,000	=	$270,000

2)

Sales	-	Gross Profit	=	Cost of Goods Sold
$600,000	-	$270,000	=	$330,000

3)

Cost of Goods Available	-	Cost of Goods Sold	=	Ending Inventory
$375,000	-	$330,000	=	$45,000

The trouble with the gross profit method is that the result is driven by the historical gross margin, which may not be the margin experienced in the most recent accounting period. Also, there may be inventory losses in the period that are higher or lower than the long-term historical rate, which can also vary the result from whatever the actual ending inventory may turn out to be.

Retail Inventory Method

Mainly used by department stores and other types of retail establishments, the retail method is based on the relationship between the costs of the goods available for sale and retail price of such goods. The ending inventory at retail is the difference between the retail prices of the goods available for sale less the sales for the period. The inventory is converted from retail to cost based upon the ratio of cost to selling price.

The Retail Method	Cost	Retail
Beginning Inventory	$60,000	$100,000
Purchases	$420,000	$700,000
Goods available for sale	480,000	800,000
Less sales		(710,000)
Ending inventory at retail		$90,000

Cost to retail ratio	$480,000/$800,000	60%
Ending inventory at cost	$90,000 x 60%	$54,000

This method only works if you consistently mark up all products by the same percentage. Also, you need to have continued to use the same mark-up percentage in the current period (discounts for periodic sales can cause incorrect results). Thus, a series of discounts to clear out stock after the main selling season of the year can impact the outcome of this calculation.

Review

Fill in the blanks.

1. ________________________ is assets acquired by the business for either future sale in the ordinary course of business or use in the production of goods or services for future sale.

2. Inventory is classified as a _________________ _________________on the balance sheet following receivables.

3. It is expected to be converted into cash within a __________________________________.

4. Items included in inventories are those items to which the business has ______________ __________________.

5. ______________________________ inventory title passes either at the point of shipping or at the point of destination.

6. ______________________________means the seller is responsible for transportation costs. Therefore ownership or title passes when the goods arrive at their destination point.

7. ____________________________________means the buyer is responsible for transportation costs. Title passes to the buyer when the inventory is loaded on the truck.

8. ____________________________is merchandise that has been placed with a consignee or agent for sale.

9. A _____________________________________is based around taking and valuing physical inventory at the end of an accounting period, usually when financial statements are prepared.

10. A ______________________________________continuously updates inventory quantities and values. When merchandise is purchased, the merchandise inventory is increased, when it is sold the amount is decreased. Thus, the balance of the inventory account always reflects the value of the inventory on hand.

Inventory Valuation

A national chain discount store carries a Model S electric toaster. The cost was different each time was ordered from the supplier this year. Details of the purchases are as follows:\

Date Purchased	Units	Cost	Total Cost
January 15	55	$18.00	$990
April 18	35	20.00	700
September12	20	25.00	500
December 14	90	27.00	2,430

A physical count of the Model S electric toaster inventory at the end of the year reveals 100 units still on hand.

PROBLEM #1

Using the above information, calculate the total cost of the Model S electric toasters as of December 31 by means of the first-in, first-out (FIFO) method.

PROBLEM#2

Using the above information, calculate the total cost of the Model S electric toasters as of December 31 by means of the last-in, first-out (LIFO) method.

PROBLEM#3

Using the above information, calculate the total cost of the Model S electric toasters as of December 31 by means of the weighted average method.

Fixed Assets and Depreciation

Fixed assets are tangible assets that are relatively permanent (which means that the asset will not be consumed during a period of less than one accounting cycle) and are needed for the production or sale of goods or services. These assets are not normally held for resale in the ordinary course of business. Fixed assets are usually termed:

- Property, plant, and equipment, or
- Fixed assets

Fixed assets are normally recorded at cost. When a business makes an acquisition of an asset for cash outright, normally the valuation for the acquired asset is the cash given up in the transaction. The cost should include any and all costs associated with obtaining the property and bringing it to its anticipated useful purpose. These costs can include, but are not limited to, any combination of the following: invoice cost, freight, sales and excise tax, insurance while in transit, special wiring and foundations, cost of test runs, interest during construction, etc.

The most useful financial record to the property appraiser is the taxpayer's depreciation schedule. The depreciation schedule will include the acquisition cost of capitalized fixed assets (subject to depreciation) description of the asset and its service life category. Depreciation schedules are maintained for both book accounting and tax accounting purposes. Understanding depreciation schedules is a very helpful tool for a personal property appraiser.

The depreciation schedule is used by accountants to calculate the measured expense to be taken within a certain revenue period. The matching principle or theory in accounting requires that expenses are to be recognized in the same period in which revenues are earned. This period is ordinarily one year. The service lives of assets are determined by regulation, either tax or book, and/or by contract in the case of leased equipment.

If an asset is expected to have a life of six years then the expense of that asset should be taken against the revenues earned in that six year period. The accountant's determination of service life may be different than that of the property appraisers. Since depreciation is an allowable expense, the accountant is more concerned with reporting a company's financial health than estimating the current fair market value of any given asset. If an asset is sold for an amount different than the net book value of the asset on the company's records, an adjustment is made for the loss or gain in value.

Businesses usually set a capitalization threshold. This threshold is a dollar amount used to determine if an asset will be capitalized and placed on the depreciation schedule or treated as an expensed item and the entire cost written off against the revenues for the current year. Any asset costing more than the threshold is capitalized while items costing less than the threshold are expensed. Expense items may still be taxable and should be listed on a return, but are not found on the depreciation schedule.

Acquisition of Truck

Fast Track Delivery purchases a delivery truck at a negotiated price of $39,500. The sales tax on the purchases is 6%. Additionally, there is a destination charge of $1,200 and a dealer prep charge of $900. The entry in the books would be as follows:

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	Date		Account Title	P.R.	Debit					Credit					
1	20X3 Oct.	15	Delivery Truck		43	9	7	0	00						1
2			Notes Payable							43	9	7	0	00	2
3															3
4															4
5															5
6															6

Price of Truck --	$39,500
Sales Tax--	2,370
Destination Charge--	1,200
Dealer Prep.---	900
	$43,970

When making an acquisition under a deferred payment plan the purchase price generally is determined by using the present value of the consideration exchanged in the transaction. (Interest to pay the loan is not capitalized—it is expensed).

With a lump sum purchase the amount paid is prorated and allocated to each individual item that was purchased.

Prorating a Purchase

Assume a business purchases a machine, a truck, and some inventory from a business that was liquidating all of its assets. The purchase price is $90,000, and the estimated market value of the acquired assets is as follows:

• Machine	$ 50,000
• Truck	20,000
• Inventory	30,000
Total	$100,000

The value would be assigned to the individual assets as follows:

Individual market value/total market value x purchase price = prorated value

Machine	50,000/$100,000	x	$90,000 =	$45,000
Truck	20,000/$100,000	x	$90,000 =	$18,000
Inventory	30,000/$100,000	x	$90,000 =	$27,000

Costs that are related to fixed assets should be added to an asset's depreciable base if future economic benefits result from the expenditure. This addition to the asset's recorded value is termed capitalization. Future economic benefits occur under the following conditions, and are added to an asset's base:

- ❖ The service life of an asset is prolonged.
- ❖ The quantity of services expected from an asset is increased.
- ❖ The quality of services expected from an asset is improved.

Depreciation

Depreciation is the term used to describe the expense that results from the loss in usefulness of an asset due to age, wear and tear, and obsolescence. The purpose of depreciation accounting is to spread the cost of an asset over its useful life, rather than treating the asset's cost as an expense in the year it was purchased. In other words, part of the cost of a depreciable asset should be transferred to an expense account during each period the asset is used in producing revenue. We will examine a few of the most popular methods of accounting depreciation on the next few pages.

Account depreciation (cost recovery) is different from appraising depreciation (loss of market value). Both forms produce an estimate of value loss but from different starting points: accounting from a historical cost figure, appraisal from the replacement or reproduction cost new as of the appraisal date. Appraisal depreciation is driven by supply and demand, interest rates, technological change, and other factors affecting the fair market value of the property.

Straight Line Method

This is a method that is very popular which yields the same amount of depreciation for each full period an asset is used. Under the straight-line method, the cost of an asset, less any trade-in value, is divided by the number of years the asset is estimated to remain useful.

Straight-line method

Facts:

Cost of a Machine	$17,000
Scrap Value	$ 2,000
Estimated Life	5 years

Calculation for straight-line method:

Cost of Asset	Salvage	Est. Life	Depreciation
($17000 -	$2000) /	5 =	$3,000

	Cost of Asset	Depreciation Amt.	Net Book Value
Year 1	$17,000	$3,000	$14,000
Year 2		$3,000	$11,000
Year 3		$3,000	$8,000
Year 4		$3,000	$5,000
Year 5		$3,000	$2,000

Practice Exercise

The Big Company acquired an asset on January 1, at a cost of $38,000, with an estimated useful life of 8 years and a salvage value of $2,000. What is the annual depreciation based on the straight-line method?

Units of Production Method

The units-of –production method allocates costs based on the estimated productive life of an asset. This method is the same as the straight-line method, except the estimated useful life is not expressed in years. Instead, it is expressed in terms of units produced (hours of operation, miles driven, service hours or some other measure of productive output).

Units of production method

Facts:

Cost	$1,000
Estimate Life	100,000 units of production
Salvage Value	$100

($1,000 – $100) divided by 100,000 is .009, or 9/10 cent per unit.

1st Yr:	25,000 units x .009	=	$225.00
2nd Yr:	17,500 units x .009	=	157.50
3rd Yr:	30,000 units x .009	=	270.00
4th Yr:	32,500 units x .009	=	292.50*
			$945.00
	*4th year not allowed:		- 45.00
	Total Depreciation	=	$900.00

Practice Exercise

An asset costing $11,500 and salvage value of $1,500 was purchased to produce an estimated 100,000 widgets and 24,000 widgets were produced within a given year. Calculate the depreciation using the units of production method for the year.

Double Declining Balance Method

The double declining balance method allows greater depreciation in the early years of an asset's life and less depreciation as the asset gets older. For this reason it is called an ***accelerated method of depreciation***. Many feel this is a more realistic method of depreciation because most assets depreciate at a greater rate during the first years of ownership.

The double declining balance method of depreciation applies a constant rate of depreciation to the declining book value of the asset. Salvage value is not considered when calculating the depreciation expense. The rate for most assets is twice the straight-line rate; hence, the name double declining balance method.

Calculating Double Declining Balance

1. Determine the depreciation rate by doubling the straight-line rate. If the asset has a life of 10 years, the straight-line rate is 10%, thus the double declining rate is 20%.
2. Compute the depreciation amount by multiplying the rate from step 1 by the book value of the asset.
3. Subtract the depreciation from the book value at the beginning of the year. It should be stressed that while salvage value is not considered in the depreciation expense calculation, an asset cannot be depreciated below its expected salvage value. Deprecation stops when an asset reaches salvage value.

Double Declining Method

Facts:

Cost of a Machine	$17,000
Scrap Value	$ 2,000
Estimated Life	5 years

	Cost	Depr. Rate	Depr. Expense	Accum. Depr. End of Year	Book Value End of Year
Year 1	$17,000.00	40%	$6,800.00	$6,800.00	$10,200.00
Year 2	17,000.00	40%	4,080.00	10,880.00	6,120.00
Year 3	17,000.00	40%	2,448.00	13,328.00	3,672.00
Year 4	17,000.00	40%	1,468.80	14,796.80	2,203.20
Year 5	17,000.00	40%	203.20	15,000.00	2,000.00

Practice Exercise

A machine was purchased for $30,000. The estimated life is six years and the salvage value is $1,500. Determine the annual depreciation for 3 years using the double declining balance method.

Sum of the Years Digits Method

The sum of the years' digits method is another accelerated depreciation method that allows a larger amount of depreciation to be recorded in the early years of an asset's life and less in later year. Under this method, the cost of an asset minus its salvage value is multiplied by a fraction. The denominator of the fraction remains constant and is obtained by summing the digits that make up the estimated useful life of the asset. The numerator changes each year and represents the number of years remaining in the life of the asset.

Calculating Sum of the Years' Digits

1. Determine the denominator, add the numbers from 1 to the number of years in the estimated life.
2. Determine the numerator, the years of life remaining.
3. Multiple the fractions by the cost of the asset minus the salvage value.

Sum of the Year's Digits

Facts:

Cost of a Machine	$17,000
Scrap Value	$ 2,000
Estimated Life	5 years

	Cost	Depr. Expense	Accum. Depr. End of Year	Book Value End of Year
Year 1	$17,000.00	5,000.00	$5,000.00	$12,000.00
Year 2	17,000.00	4,000.00	9,000.00	8,000.00
Year 3	17,000.00	3,000.00	12,000.00	5,000.00
Year 4	17,000.00	2,000.00	14,000.00	3,000.00
Year 5	17,000.00	1,000.00	15,000.00	2,000.00

Year 1: =[5/(1 + 2 + 3 + 4 + 5)] X (17,000 - 2,000)
=(5/15) X 15,000
=5,000

Year 2: =[4/(1 + 2 + 3 + 4 + 5)] X (17,000 - 2,000)
=(4/15) X 15,000
=4,000

Year 3: =[3/(1 + 2 + 3 + 4 + 5)] X (17,000 - 2,000)
=(3/15) X 15,000
=3,000

Practice Exercise

The cost of an asset is $38,000. The expected useful life is 8 years and the asset can be sold for $2,000 and the end of its expected useful life. What is the depreciation for 3 years using the sum of the years' digits method?

Accelerated Cost Recovery Systems

When Congress enacted the Economic Recovery Tax Act of 1981, it introduced a new system for figuring depreciation: the Accelerated Cost Recovery System (ACRS). ACRS was meant to encourage businesses to invest in new assets by allowing them to write the asset off more quickly than had been possible in the past. ACRS applies only to depreciation on federal income tax returns and only to assets placed into service after 1980.

ACRS is the least complex of all depreciation methods. It is not necessary to estimate a useful life of an asset, to consider salvage value, or to be concerned about the time of year that an asset was placed into service.

For tax years 1981-1986, assets were assigned to a recovery period based on the following classes:

- Three-year property: Automobiles, light duty trucks, machinery & equipment used for research and experimentation.
- Five-year property: All the property that does not fall under any other class.
- Ten-year property: Railroad tank cars, theme park structures, residential mobile and prefab homes, and certain public utility property.
- Fifteen-year property: Other public utility property.

To illustrate the use of ACRS for assets placed into service between 1981 and 1986, consider an automobile placed into service in 1983 for $12,000. The automobile is three-year property and the depreciation factors are .25, .38, and .37, respectively. (Note the total of the factors =1.00, remember that salvage value is not considered in ACRS.)

ACRS

	Cost	Depr. Expense	Accum. Depr. End of Year	Book Value End of Year
Year 1	$12,000.00	3,000.00	$3,000.00	$9,000.00
Year 2	$12,000.00	4,560.00	7,560.00	4,440.00
Year 3	$12,000.00	4,440.00	12,000.00	0.00

The Tax Reform Act of 1986 introduced the second version of ACRS. It is known as the Modified Accelerated Cost Recovery System (MACRS). It applies to all tangible assets placed into service after December 31, 1986. Under MACRS, the four original classes of property were kept, and two new ones were added (7 year and 20 year property). The process for calculating depreciation remains basically the same, however, some classifications were changed. You can refer to IRS Publication 946 for classification of property and further instructions.

Final Notes on Depreciation

The above methods assume that each asset depreciates independently of other assets and total depreciation for all assets for the period is simply the sum of individual depreciation amounts. In actual practice, many companies apply a depreciation method to all assets within a specified classification. This is termed group depreciation. For example, if office furniture and fixture account assets have an estimated lives ranging from six to fourteen years, a rate based on average life of ten years may be applied to the total cost of all office furniture and fixtures. Upon retirement, it is assumed to be fully depreciated and is assumed that some assets will be over depreciated and other under appreciated and that gains and losses will equalize over a period of time.

Remember, the cost of an asset less its accumulated depreciation is the book value of an asset. Book value should not be confused with market value. Market value is what an asset could sell for on a certain date; it has no direct relationship to the calculations that are made for accounting/income tax depreciation. Book value is the amount of cost not yet allocated as depreciation expense.

Review

Match the appropriate term with the definition that best describes it.

1. _____ Depreciation
2. _____ Valuation
3. _____ Straight-line method
4. _____ Sum of the years' digits method
5. _____ Double declining balance method
6. _____ Accelerated depreciation
7. _____ Salvage value

a) This depreciation method uses a decreasing fraction each succeeding year to multiply by the depreciable cost.

b) This depreciation method charges a higher amount of depreciation in the early years of an asset's life.

c) Market Value of a fixed asset at the end of its service.

d) This depreciation method depreciates an asset over time on the basis of years.

e) The value placed on fixed assets.

f) A term businesses use to charge the cost of fixed assets to operations.

g) This depreciation rate is double the straight-line method.

Accounting Depreciation

A fast food restaurant started business last year with new equipment. At that time, the equipment cost $90,000.00 and had an estimated economic life of 8 years. It is anticipated that at the end of its cost recovery period, the salvage value of the restaurant equipment will be $10,000.00

a. Using straight line depreciation, how much depreciation will be allocated for this year?\

b. Assuming double declining balance depreciation is used, what is the net book value of the equipment at the end of this (the second) year?

c. Using sum of the years' digits, what will be the accumulated depreciation after three years?