

# Chapters 1-4 (Part One)

## **Profession of Accounting**

The accounting profession is varied. It includes private accounting, where accountants work for their clients (e.g., Controllers). It also includes public accounting, where accountants are independent of their clients (e.g., CPAs).

Financial accounting refers to the preparation of financial statements primarily for outsiders (e.g., investors, government regulators, and creditors). This is done by the internal accountants and then certified by the public accountants.

Managerial or management accounting refers to the preparation of internal reports for the management of the company.

Tax accounting refers to the preparation of federal, state and local tax returns.

## **Forms of Business Organizations**

We will focus on corporate financial statements, but there are other entities and their financial statements look different. There are sole proprietorships (one owner), partnerships (two or more owners), and other entities as well. With these two forms of doing business, the law treats the owner(s) as doing business. Any debts of the business are debts of the owners and they unlimited liability for the debts of the business.

Corporations are legal entities that are separate from their owners. It is the corporation that is conducting the business, not the owner. Therefore, the debts of the business are the corporation's debts, not the owner's debts. Shareholders of corporations have limited liability. In other words, the shareholders can lose their investment in the corporation, but usually, creditors of the corporation may not come after the shareholders for any additional amounts. This is a major advantage of using the corporate form. Another reason that corporations are favored is because our capital markets are geared towards selling stock rather than partnership interests, and it is easier to sell stock than to sell partnership interests. Therefore, corporations find it easier to raise equity capital than do other investment vehicles.

Partnerships and sole proprietorships, however, have tax advantages over corporations. Because corporations are separate from their owners, they pay taxes on their income. When corporations pay dividends to their shareholders, the dividends are treated as taxable income to their shareholders, who pay a second tax on that income. With partnerships and sole proprietorships, the business does not pay taxes, the owners pay taxes once on the income earned. The owners are then free to withdraw the income from the business free of income tax.

Your book mentions that the total number of partnerships and sole proprietorships exceeds the number of corporations by 5 to 1, but the amount of equity capital of corporations exceeds that of partnerships and sole proprietorships by 8:1. According to another source:

- More than 70% of the businesses in the United States are organized as proprietorships.
- About 10% of businesses are organized as partnerships.
- About 20% of businesses are organized as corporations; however, they generate over 90% of the total dollars of business receipts.

Limited Liability Companies (LLCs) and Limited Liability Partnerships are newer forms of doing business.

### **Users of Financial Information**

There are several groups of users of financial information. Sometime these users are called business stakeholders. A business stakeholder is "a person or entity that has an interest in the economic performance of the business."

Stakeholders include internal and external users of financial information. Internal users include marketing managers, production supervisors, finance directors and other company officers. External users include investors, creditors, employees, customers, and various government agencies. These stakeholders use accounting data to gauge the economic performance of businesses.

The following table provides examples of the type of financial information that would of interest to various internal and external users of financial information.

<b><u>Stakeholder</u></b>	<b><u>Interested In</u></b>	<b><u>Reason</u></b>
<b>A. Owner</b>	<b>Sales</b>	<b>Is advertising effective?</b>
	<b>Profit</b>	<b>Can I take home more money each week?</b>
	<b>Cash</b>	<b>Can I afford to buy more equipment?</b>
<b>B. Investors/ Stockholders</b>	<b>Profit</b>	<b>Is my investment making money?</b>
	<b>Dividends</b>	<b>What dividends are being paid?</b>
<b>C. Bankers</b>	<b>Debts</b>	<b>Can this business repay a loan?</b>
<b>D. IRS</b>	<b>Profit</b>	<b>What taxes does this business owe?</b>
<b>E. Managers</b>	<b>Expenses</b>	<b>Am I keeping expenses within my budget?</b>
	<b>Sales</b>	<b>Will I be eligible for a bonus this year?</b>
<b>F. Employees</b>	<b>Profit</b>	<b>Can my company afford raises?</b>
		<b>Is my job secure?</b>

<b>G. Regulators</b>	<b>Operations</b>	<b>The SEC and state securities agencies asks, “Do the financial information provided to investors accurately reflect operations?”</b>
<b>H. Customers</b>	<b>Amount spent on warranty</b>	<b>Bank Regulators ask, “Is the bank engaging only in permitted activities?”</b> <b>How dependable is this product?</b> <b>How responsive is the service claims department?</b>
<b>I. Competitors</b>	<b>Amount spent on ads</b>	<b>How do I compare to my competitor?</b>

Because competitors can gather valuable information about their competitors from the competitors’ financial statements, companies try to provide as general information on their financial statements as possible.

### **Business Activities**

Businesses are involved in three basic types of activities:

- financing activities
- investing activities
- operating activities

Accounting provides information on these activities.

### **Financing Activities**

Capital is needed during the formation and operation of a business. Capital can be provided through debt (liabilities) and/or equity. Examples of liabilities or debt include formal borrowings (e.g., Notes Payable) as well as the short-term extension of credit by suppliers (e.g., Accounts Payable), employees (e.g., Wages Payable), and government (e.g., Taxes Payables). Formal debt issued by a corporation (Notes Payable or Bonds Payable) does not dilute an owner’s ownership of the business. This is a major advantage of debt. The disadvantage of providing capital through debt is that debt has to be paid back (often with interest).

When a corporation wishes to raise capital through issuing capital, it can sell stock. There are various forms of stock. The basic form of corporate stock is common stock. The holders of common stock are the residual owners of a corporation. The disadvantage of equity financing is that the owner dilutes his or her ownership percentage by issuing new equity. The advantage of equity

financing is that equity does not have to be returned. Shareholders may receive a share of the corporation's profits through the payment of dividends. Unlike interest, however, there is no obligation for a corporation to pay dividends

### **Ethics Perspective**

As your book notes, the failure to provide accurate financial information hurts a number of innocent parties. Enron provides one of the most infamous examples of this effect. Not only did the failure to accurately report the financial operations hurt Enron investors, but it also hurt the entire stock market because it severely shook the trust that investors had in financial information.

It is important that accountants and officers of companies to act ethically. This is not just a case of morals. It should be noted that there are severe consequences for individuals who participate in the distribution of false and/or misleading financial information. An ethical violation can lead to civil or criminal liability for the violation. Officers and accountants can lose their livelihoods over ethical violations. They can also be liable for huge financial judgments to shareholders for such violations. A serious violation can result in prison sentence. We have seen this in the Enron scandal. The accountants and management personnel who participated in that distribution face severe financial penalties and prison sentences. **IT ISN'T WORTH IT.**

### **Investing Activities**

Investing involves the acquisition of resources by a business. The resources that businesses use in their operations are called assets. Assets can be generated by financing transactions. For example, cash is generated from sales of common stock, and bank loans. Equipment (Property, Plant & Equipment) is paid for with available cash and borrowings.

Assets are also generated by operations. For example, Accounts Receivables and cash are generated by sales to customers. Although your book calls this an investing activity, in the context of the Statement of Cash Flows, these activities are considered operating activities.

### **Operating Activities**

A business internally generates capital through its operations (revenues). Examples of revenues include sales revenue, service revenue, and interest revenue. The costs of generating this capital (revenues) are expenses. Examples of these expenses include cost of goods sold (the cost of inventory sold), selling expenses, marketing expenses, administrative expenses, and interest expense.

When its revenues exceed its expenses, a business has net income. When expenses exceed revenues, a net loss results.

There are generally three types of businesses:

- Manufacturing Businesses
- Merchandising Businesses
- Service Businesses

### **Communicating With Users of Financial Statements**

Accounting can be thought of as an information system that provides reports to stakeholders (users of financial statements) about the economic activities and condition of a business.

There are four basic financial statements:

- Balance Sheet
- Income Statement
- Statement of Retained Earnings
- Statement of Cash Flows

In order for users of financial statements to obtain a fuller picture of the operations of the issuing business, comparative financial statements are often provided. With comparative financial statements, the activities of more than one year are reported with each year's information appearing in a separate column. The most recent year is reported on the left.

### **Balance Sheet**

The Balance Sheet is prepared as of a given date. It is usually the end of the reporting period. Corporations can report their operating results using a calendar year or a fiscal year (a 12-month period other than a calendar year). It reports the financial position of the company as of a given date.

The Balance Sheet reports the assets, liabilities and the net worth of the company. These are usually reported at the original cost of the item in question (not the fair market value). Therefore, the Balance Sheet is not claiming to show the current value of the company.

The Balance Sheet is organized as follows:

<b>Balance Sheet</b>	
<b>Assets</b>	<b>Liabilities</b>
	<b>Owner's Equity</b>

One way to think of a Balance Sheet is that one side reports the resources (assets) of a business, and the other side reports the claims against those resources. The claims of the creditors are liabilities and the claims of the investors are equity. The resources equal the claims on those resources, which leads to the Basic Accounting Equation, which is often called the "Balance Sheet Equation:"

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

The net worth or equity section of a corporate balance sheet is divided into two parts. One part is the part that the shareholders contribute to the corporation. This is called Paid-In Capital (Contributed Capital). The second part is the earnings that the corporation earns for itself that it keeps and does not give to its shareholders via dividends. These earnings are called Retained Earnings.

### Income Statement

The Income Statement reports the results of the companies operations for the reporting period. It is dated "For [Period] Ended [Date]." For example, the latest Income Statement for a calendar year company might be dated "For the Year Ended December 31, 1998." The Income Statement gives the revenues, expenses and net income of the company for the period in question.

The selling of capital stock or borrowing of funds does not generate revenues. Similarly, the paying of dividends is not an expense.

#### **Income Statement** **For the Year Ended \_\_\_\_\_**

<b>Revenues</b>	<b>\$ XXXX</b>
<b>Expenses</b>	<b><u>-XXXX</u></b>
<b>Net Income</b>	<b><u>\$ XXXX</u></b>

Most publicly traded corporations report their income using the accrual method. Under the accrual method, you have revenue when you earn it -- not when you actually receive it. Also, you have expenses when you owe them -- not when you

pay them. Accountants prefer this because you match the revenues with the expenses that generated them. If you used the cash method (revenue reported when received and expenses reported when they are paid), companies can manipulate their income.

### **Statement of Retained Earnings**

The Statement of Retained Earnings explains the change in the Retained Earnings from last year to this year. It shows:

#### **Statement of Retained Earnings For the Year Ended \_\_\_\_\_**

<b>Beginning Balance of Retained Earnings</b>	<b>\$ XXXXX</b>
<b>Plus Net Income for the Year</b>	<b>+XXXXX</b>
<b>Less Dividends for the Year</b>	<b><u>-XXXXX</u></b>
<b>Ending Balance of Retained Earnings</b>	<b>\$ XXXXX</b>

The dividend history of companies is very important to investors. The Statement of Retained Earnings provides a summary of that history.

### **Statement of Cash Flows**

The Statement of Cash Flows was introduced around 1986 because people complained that with the accrual method they had difficulty telling whether the company was actually receiving the income that it was accruing. The Statement of Cash Flows reports the cash inflows and outflows that the company has from its operations (what it does for a living), investing (purchases and sales of equipment, real estate and other assets), and financing (stock and debt transactions). The Statement of Cash Flows explains how cash changed during the year.

#### **Statement of Cash Flows For the Year Ended \_\_\_\_\_**

<b>Cash Flows From Operations</b> (Details given line by line like an Income Statement):	<b>\$ XXXXX</b>
<b>Cash Flows From Investing</b> (Details given line by line like an Income Statement):	<b>XXXXX</b>
<b>Cash Flows From Financing</b> (Details given line by line like an Income Statement):	<b><u>XXXXX</u></b>
<b>Cash Flows For the Year:</b>	<b>\$ XXXXX</b>
<b>Plus Balance of Cash at Beginning of Year:</b>	<b><u>XXXXX</u></b>
<b>Balance of Cash at End of Year</b>	<b>\$ XXXX</b>

## **Interrelationships of Statements**

All of the financial statements reports on different aspects of the same operations. Some examples:

- The net income reported in the Income Statements is the same net income reported in the Statement of Retained Earnings.
- The change in the retained earnings reported on the Balance Sheet from last year to the current year is explained in the Statement of Retained Earnings.
- The change in the amount of cash reported on the Balance Sheet from last year to the current year is explained in the Statement of Cash Flows.

## **Other Comments on Financial Statements**

At the end of the financial statements you will find the Notes to the Financial Statements. These Notes convey a great deal of important information on:

- The accounting rules and conventions that were followed in preparing the financial statements.
- Additional details about the figures appearing in the financial statements.
- Additional information not appearing in the financial statements (e.g., lines of credit, bank covenants & contingent liabilities)

The financial statements are accompanied by a letter from the accountants preparing the financial statements. The letter describes how the audit of the company was conducted, and it states the accountant's opinion on whether the financial reports were prepared in accordance with generally accepted accounting principals (GAAP). Stakeholders are looking for an unqualified opinion from the CPA. Without an unqualified opinion, stakeholders cannot have complete confidence that the financial statements give an accurate picture of the company's financial health.

The financial statements also have a management discussion and analysis section. It discussed the company's ability to pay near-term obligations, its ability to fund operations and expansion, and its results of operations. It analyzes trends in the company's operations and identifies significant events and uncertainties that affect the company's operations.

These financial statements are the basic financial statements that investors, creditors and regulators expect to see for each corporation.

## **Generally Accepted Accounting Principles**

Financial statements are prepared according to Generally Accepted Accounting Principles (GAAP). GAAP is the set of rules that all accountants try to follow in

preparing financial statements. The thought is that if everyone follows the same rules, then the reader of the financial statements can have more confidence that he or she understands the financial statements using a lesser amount of time than would be the case if the reader had to try to understand the format the corporation is using as well.

This was not always the case. Although the basic accounting rules were developed during the Renaissance by an Italian monk to record the profits of caravans and other business ventures, prior to 1933, companies were free to use whatever rules that they wanted in preparing financial statements. With the stock market crash of 1929, the federal government wanted to protect investors and creditors. The Securities Act of 1933 and The Securities Exchange Act of 1934 require most publicly traded corporations to prepare financial statements in accordance with rules promulgated by the Securities and Exchange Commission (SEC).

The SEC often allows the accounting profession to establish GAAP, but if the SEC isn't happy with GAAP, then it can require some other reporting rules be followed with governmental filings and reports to shareholders. Although it has changed over the years, the current group (since 1979) that rules on GAAP is the Financial Accounting Standards Board (FASB).

### **Assumptions and Principles**

To develop accounting standards, the FASB relies on some key assumptions and principles.

**Monetary Unit Assumption.** This assumption requires that only those things that can be expressed in money are included in the accounting records. For example, customer satisfaction is important to every business, but it is not easily quantified in dollar terms; thus it is not reported in the financial statements. The monetary unit used is the national currency of the country in which the corporation exists.

**Economic Entity Assumption.** This is also called the Business Entity or Separate Entity Assumption or Concept. Each business must be accounted for as an individual organization. Therefore, even though you are conducting business as a sole proprietorship (not a separate legal entity), you still prepare financial statements covering only the business operations. You do not include your personal assets and income.

**Time Period Assumption.** This is also called the Accounting Period Assumption or Concept. This assumption states that the life of a business can be divided into artificial time periods (e.g, year or quarters), and that useful reports covering those period can be prepared for the business.

**Continuity Assumption.** This is also called the Going Concern Assumption or Concept. Financial statements assume that the company will not be going out of business. This influences how financial statements are prepared. For example we value inventory at the lower of cost or market. The market value of inventory is typically the replacement cost. If we assumed that the business was liquidating, we would report the inventory at its liquidation value, which is probably lower.

**Cost Principle.** Although there are exceptions, most transactions are recorded using historical cost. A building is recorded using the purchase price, not its fair market value. So the Balance Sheet does not purport to reflect the actual value of the company -- just its book value.

The cost concept follows from the objectivity concept, which requires that accounting records and reports be based upon objective evidence. GAAP is also motivated by conservatism. Under the conservatism assumption/concept accountants should value items conservatively.

**Full Disclosure Principle.** All circumstances and events that would make a difference to stakeholders should be disclosed in either the financial statements or the notes to the financial statements.

### **Characteristics of Useful Information**

To be useful, information should possess these qualitative characteristics: relevance, reliability, comparability, and consistency.

**Relevance.** Information is relevant if it will influence investment decisions. To be relevant it must also be timely.

**Reliability.** Information is reliable if it can be depended on. It must be verifiable, neutral and a faithful representation of what it purports to be.

**Comparability.** Information is presented so decision makers can recognize similarities, differences, and trends over different time periods or between different companies. The financial statements follow same general rules. In order to aid in the comparison, each company must disclose the accounting methods used.

**Consistency.** Accounting procedures and methods, once adopted, should continue to be used from year to year. There are rules for changing accounting procedures that a company uses.

**Materiality.** Material items must follow GAAP. Companies need not follow GAAP for items that are immaterial. This is a subjective concept. If

an investment or other financial decision would be affected by the size of item in question, it is material.

**Conservatism.** When preparing financial statements, a company should choose the accounting method that will be least likely to overstate assets and income.

### **The Accounting Process**

Imagine that you want to report on your wealth (or financial net worth). This could happen because you want to borrow money from a friend, and you want to assure them that you can pay back the loan. What if you own a house for which you just paid \$250,000. You could report that you have this house, and you have a net worth \$250,000.

Just because you own the house does not mean that you are really worth \$250,000. For example, what if you borrowed the \$250,000 purchase price from your parents. You are not really worth \$250,000. You have an asset worth \$250,000 and a liability for \$250,000. So you have a zero net worth.

Imagine that you have no assets or liabilities. In other words, you have a zero net worth. All you have is a credit card with a credit line of \$10,000. You take the credit card and get a cash advance of \$10,000. Are you richer than you were before you received the cash advance? Sure, you have \$10,000 in cash, but you now have a \$10,000 debt. So you still have a zero net worth.

In order to give a full disclosure as to your net worth, you have to report your assets, liabilities and net worth (or in accounting terms, "equity").

A Balance Sheet attempts to provide this disclosure through information regarding a firm's assets, liabilities and equity. A firm's assets are paid for, directly or indirectly, with either liabilities or equity. As a result of this relationship, a firm's assets are equal to its liabilities plus its equity. As noted above, this relationship is referred to as the balance sheet equation:

$$\text{Assets} = \text{Liabilities and Owner's Equity}$$

This relationship is reflected in the Balance Sheet:

<b>Balance Sheet</b>	
<b>Assets</b>	<b>Liabilities</b>
	<b>Owner's Equity</b>

While Balance Sheets can have different formats, we will use the format set forth above. Under this format, the left-hand side of the Balance Sheet (assets) is equal to the right-hand side (liabilities and equity).

Each asset, liability and equity item is represented by an account. There is a great deal of flexibility in the names given to accounts. Each account has two sides (just like the Balance Sheet). The left-hand side of the account is the debit side of the account. The right-hand side of the account is the credit side of the account. For example, one asset account that a firm will have is cash.

Cash	
Debits	Credits

The debits and credits in any account are netted to give the balance in the account at a given time.

The accounts regarding assets, liabilities and equity are summarized in Balance Sheet. If an account appears on the left-hand side of the Balance Sheet (asset), then the account will normally (not always) have a debit balance. If an account appears on the right-hand side of the Balance Sheet (liabilities and equity), then the account will normally have a credit balance.

With an account that normally has a debit balance (e.g., an asset), if you want to increase that account, you debit it some more. In other words, you add to the debit balance. If you want to decrease it, you credit it. In other words, you are adding to the side that will be netted against its balance, thereby decreasing that balance. Similarly, if an account normally has a credit balance (e.g., a liability or equity account), if you want to increase it, you credit it some more, and if you want to decrease it, you debit it.

The order in which the accounts appear in the Balance Sheet follows the certain convention. Assets are listed by how soon they will be converted into cash. Thus, cash is the first line of the Balance Sheet. Liabilities are listed by how they will be paid. Equity accounts are listed by their priority of payment upon liquidation.

Business transactions are recorded in the accounts. The changes to the accounts are summarized in the General Journal. For each transaction, the General Journal states which accounts are credited and which accounts are debited. These General Journal entries take the following form:

D. Name of the Account Debited	\$XXX	
Cr. Name of the Account Credited		\$XXX

## ILLUSTRATION

A. Assume that the firm is a corporation. Equity in the corporation is represented by stock. There are different types of stock. We will only deal with one type here, common stock. When stock is sold, you are increasing the equity in the firm. Because cash (or other property) is given to the corporation, the assets (e.g., cash) have increased and those assets did not come from debt. Thus the net worth, or equity, is thereby increased. Assume \$100,000 of common stock is sold. The equity account here is Common Stock. Because cash, an asset, has increased, it is debited. Equity is on the right-hand side of the balance sheet, and it normally has a credit balance. In order to increase equity, as is the case in this transaction, you credit the equity account, Common Stock:

D. Cash	\$100,000	
Cr. Common Stock		\$100,000

B. Purchase of Equipment for \$5,000 cash:

D. Equipment	\$5,000	
Cr. Cash		\$5,000

Ask yourself what is going on here. Your equipment has increased by \$5,000. Equipment is an asset. Assets appear on the left-hand side of the Balance Sheet. Therefore, to increase the asset, you debit the left-hand side of the account. Your cash has gone down. Cash is an asset. Again, remember that assets appear on the left-hand side of the Balance Sheet, and to decrease an asset you must credit the right-hand side of the account.

C. Purchase of Equipment in exchange for a promissory note for \$10,000.

D. Equipment	\$10,000	
Cr. Notes Payable		\$10,000

As was true before, you increase the asset of equipment by debiting the left-hand side of equipment. In this transaction, your liabilities are going up. Liabilities are on the right-hand side of the Balance Sheet. To increase a liability, you credit the right-hand side of the account. The liability here is called Promissory Note. With a promissory note, the debtor does more than merely owing money to the creditor. The debtor here executes a formal document in which he or she promises to pay the debt.

D. Purchase of Supplies for \$10,000 on credit (no formal promissory note is given).

D. Supplies	\$10,000	
Cr. Accounts Payable		\$10,000

Supplies is an asset, and it is increasing. Because an asset is on the left-hand side of the Balance Sheet, debiting the left-hand side of the account increases it. In this transaction, a different liability is increasing. Because Accounts Payable is a liability, the account appears on the right hand side of the Balance Sheet. Thus, to increase the account, you must credit the right-hand side of the account. The liability here is an account payable. With an account payable, there is no formal document. The debtor merely owes the money. For example, the debtor tells the stationary store to send over letterhead, and the store also sends a bill for the amount owed.

E. Purchase of Land and Building for \$100,000.

When you pay one price for a bundle of assets, you must allocate the purchase price between the assets acquired according to their fair market value. Assume that the land is worth \$10,000 and the building is worth \$90,000. The \$100,000 is paid for partly in cash (\$20,000) and partly by delivering a promissory note (\$80,000).

D. Land	\$10,000	
Building	\$90,000	
Cr. Cash		\$20,000
Notes Payable		\$80,000

Here your assets are increasing. Assets are normally have a left-sided balance, and they are increased through debits. Also, your liabilities are increasing. Liabilities normally have a right-sided balance, and they are increased through credits.

F. Pay the principal of \$6,000 on a promissory note.

D. Notes Payable	\$6,000	
Cr. Cash		\$6,000

Here, the liability is going down (you are paying it off). Liabilities appear on the right-hand side of the Balance Sheet, and therefore, to decrease a liability you debit the left-hand side of the account. Here the asset of cash is going down. To decrease an asset, you credit the right-hand side of the account.

## **Income Statement**

As noted above, a firm's net worth (or equity) increases from contributions from its owners (e.g., the sale of stock), as well as the generation of profits its operations. The generation of profits is reflected in certain accounts. Inflows to the firm are reflected in revenue accounts, and outflows from the firm are reflected in expense accounts. Revenues less expenses give you the firm's Net Income. Information regarding these accounts is summarized in the Income Statement.

Revenues increase a firm's equity or net worth. Because equity appears on the right-hand side of the Balance Sheet, it normally has a credit balance. You, therefore, increase an equity account by crediting the right-hand side of the account. Because revenues increase equity, then revenues will normally have a credit (right-hand side) balance. Because expenses decrease equity, then expense accounts will normally have a debit (left-hand) balance.

### **Illustration (Continued)**

G. Assume that our firm is a consulting firm, and that the firm has earned consulting commissions of \$50,000. The client has not yet paid these commissions.

D. Accounts Receivable	\$50,000	
Cr. Consulting Revenue		\$50,000

We did not receive any cash, but we still have an asset. That asset is the right to collect the money from our client. That right is called an Account Receivable (and its plural is called Accounts Receivable). So, two things have happened. First, our assets have increased. Second, as a result of our firm's generating revenue, the firm is worth more, so our equity has increased. Accounts Receivable is an asset that has increased, thus we debit the account's left-hand side. Consulting Revenue is a revenue account and revenues increase equity. Thus, crediting the right-hand side of the revenue account increases it.

H. The firm pays salaries of \$20,000.

D. Salary Expense	\$20,000	
Cr. Cash		\$20,000

Cash has gone down. To decrease an asset (normally a debit balance account), you credit it. The firm is worth less. This is reflected in the expense account. To decrease the equity in the firm (normally a credit balance account) you debit the expense account.

I. The firm uses \$3,000 of its supplies.

D. Supplies Expense	\$3,000	
Cr. Supplies		\$3,000

The firm's supplies have gone down. Supplies is an asset (normally a debit balance account), and you decrease it by crediting it. The equity in the firm has gone down. Equity (normally a credit balance account) has gone down, and you decrease it by debiting the expense account.

J. The firm owes one month's rent.

D. Rent Expense	\$5,000	
Cr. Rent Payable		\$5,000

The firm hasn't paid its rent yet. So no asset has gone down yet. The firm owes the rent, so its liabilities have gone up. Liabilities are on the right-hand side of the balance sheet, and normally have a credit balance. To increase liabilities you credit them. The firm's equity has gone down. Equity normally has a credit balance, you decrease it by debiting an expense account.

### **Trial Balance**

At the end of the accounting period, an accountant will do a trial balance in order to help in locating errors made in the recording process. All the accounts with debit balance are totaled and all of the accounts with credit balances are totaled. The total debit balances should equal the total credit balances. A number of trial balances are conducted during the accounting cycle.

### **Closing Entries**

Finally you have to reflect the revenues and expenses in the equity account. First, you close the revenue and expense accounts to the income summary account. Then you close the Income Summary Account to the Retained Earnings Account.

### **Illustration (Continued)**

K. Close out the revenue account.

D. Consulting Revenue	\$50,000	
Cr. Income Summary		\$50,000

L. Close out the Salaries Expense account.

D. Income Summary	\$20,000	
Cr. Salaries Expense		\$20,000

M. Close out the Supplies Expense account.

D. Income Summary	\$3,000	
Cr. Supplies Expense		\$3,000

N. Close out the Rent Expense account.

D. Income Summary	\$5,000	
Cr. Rent Expense		\$5,000

O. Close out the Income Summary account.

D. Income Summary	\$22,000	
Cr. Retained Earnings		\$22,000

**GENERAL LEDGER**

CASH	
100000 (A)	5000 (B)
	20000 (E)
	6000 (F)
	20000 (H)
-----	-----
49000	

ACCOUNTS RECEIVABLE	
50000 (G)	
-----	-----
50000	

SUPPLIES	
10000 (D)	3000 (I)
-----	-----
7000	

EQUIPMENT	
5000 (B)	
10000 (C)	
-----	-----
15000	

BUILDING	
90000 (E)	
-----	-----
90000	

LAND	
10000 (E)	
-----	-----
10000	

ACCOUNTS PAYABLE	
	10000 (D)
-----	-----
	10000

RENT PAYABLE	
	5000 (J)
-----	-----
	5000

NOTES PAYABLE	
6000 (F)	10000 (C)
	80000 (E)
-----	-----
	84000

COMMON STOCK	
	100000 (A)
-----	-----
	100000

**CONSULTING REVENUE**

<b>50000 (K)</b>	<b>50000 (G)</b>
-----	-----
	<b>0</b>

SALARY EXPENSE	
20000 (H)	20000 (L)
-----	-----
0	

SUPPLIES EXPENSE	
3000 (I)	3000 (M)
-----	-----
0	

RENT EXPENSE	
5000 (J)	5000 (N)
-----	-----
0	

INCOME SUMMARY	
20000 (L)	50000 (K)
3000 (M)	22000 (O)
5000 (N)	
-----	-----
	0

RETAINED EARNINGS	
	22000 (O)
-----	-----
	22000

### INCOME STATEMENT

Revenue:		\$50,000
Expenses:		
Rent Expense:	\$ 5,000	
Supplies Expense:	3,000	
Salary Expense:	20,000	
	-----	
Total Expenses:		(28,000)
		-----
Net Income:		\$22,000

### BALANCE SHEET

Assets		Liabilities	
Cash	\$ 49,000	Accounts Payable	\$ 10,000
Accounts Receivable	50,000	Rent Payable	5,000
Supplies	7,000	Promissory Note	84,000
Equipment	15,000	Equity	
Building	90,000	Common Stock	100,000
Land	10,000	Retained Earnings	22,000
	-----		-----
Total Assets:	\$221,000	Total Liab. & Equity	\$221,000
	=====		=====

When the other parts of the equity of a corporation have changed (e.g., common stock) besides retained earnings, then corporations will use a Statement of Changes in Shareholder Equity rather than a Statement of Retained Earnings.

### STATEMENT OF CHANGES IN SHAREHOLDER EQUITY

	Common Stock	Retained Earnings
<b>Beginning Balance:</b>	\$ 0	\$ 0
<b>Sale of Shares of Common Stock</b>	100,000	
<b>Net Income</b>		22,000
	-----	-----
<b>Ending Balance:</b>	\$100,000	\$22,000

### STATEMENT OF CASH FLOWS

<b>Cash From Operations:</b>		
<b>Net Income:</b>	\$22,000	
<b>Increase in Accounts Receivable</b>	(50,000)	
<b>Increase in Supplies</b>	(7,000)	
<b>Increase in Accounts Payable</b>	10,000	
<b>Increase in Rent Payable</b>	5,000	
	-----	
		(\$20,000)
<b>Cash From Investing:</b>		
<b>Purchase Equipment:</b>	(15,000)	
<b>Purchase Building:</b>	(90,000)	
<b>Purchase Land:</b>	(10,000)	
	-----	
		(115,000)
<b>Cash From Financing:</b>		
<b>Issue Promissory Notes:</b>	84,000	
<b>Issue Common Stock:</b>	100,000	
	-----	
		184,000
		-----
<b>Net Increase in Cash During the Year:</b>		\$49,000
<b>Cash Balance at the Beginning of the Year:</b>		0
		-----
<b>Cash Balance at the End of the Year:</b>		\$49,000

## **Corporations vs. Sole Proprietorships & Partnerships**

We have focused on the journal entries for a corporation. The journal entries used to account for the equity of a sole proprietorship or a partnership are different.

When capital is given to a sole proprietorship or a partnership, the journal entry is similar to the sale of stock by a corporation:

D. Cash	\$100,000	
Cr. John Smith, Capital		\$100,000

When cash is distributed from a sole proprietorship or a partnership to its owner/partner, the journal entry is:

D. John Smith, Drawing	\$5,000	
Cr. Credit		\$5,000

In the case of a corporation distributing funds to its shareholder, a similar journal entry exists:

D. Dividends	\$5,000	
Cr. Cash		\$5,000

Both dividends and the drawing account are temporary (nominal) accounts that get closed to the equity account that appears on the balance sheet. In the case of the sole proprietorship or partnership:

In the case of a corporation:

D. Retained Earnings	\$5,000	
Cr. Dividends		\$5,000