Double Entry Accounting Workbook

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Double Entry Accounting Workbook Table of Contents

| Introduction | 2 |
|----------------------------------|--------|
| Financial Statement Introduction | 3 |
| Financial Transactions | 4 |
| Debits and Credits | 4 |
| Journal Entries | 10 |
| Chart of Accounts | 16 |
| General Ledger/T-Accounts | 18 |
| Trial Balance | 19 |
| Accounting Types | 25 |
| Order of Liquidity | 28 |
| Account Numbers | |
| Financial Statements | |
| Income Statements | 31 |
| Break-Even Point | 33 |
| Balance Sheet | |
| *Bonus Material | |
| Closing Journal Entry | 38 |
| General Ledger Examples | |
| Depreciation | 44 |
| Cash Flow Statement | |
| Subledgers | 49 |
| Accounts Payable | 49 |
| Accounts Receivable | |
| Bank Reconciliation | 55 |

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^{*}Disclaimer: The information in this book is written from my experience, research and training. I do not write with authority from any Accounting Standards organization

Double Entry Accounting Workbook

Introduction:

The subject of this workbook is the Double Entry Accounting System. This system has been in use since at least the 12th century and it continues to be the most effective financial accounting system today. Double Entry Accounting is surprisingly simple and is built around only a very few concepts, a balance between what a business has, where the business got what it has and how to organize the answers to those questions. With those few concepts, the Double Entry System successfully provides financial accounting for any size of business in any industry.

This workbook is focused on the things you need to know before you use accounting software and before you read financial statements. It starts with the central system of accounting with the least amount of detail possible so that you can quickly understand the concepts. The main elements of the central system are Debits, Credits, Journal Entries, the General Ledger and Financial Statements. The Financial Statements and reports we cover are the Trial Balance, Income Statement and Balance Sheet.

Performing accounting tasks and accessing accounting data has been made much more efficient by software which is able to take advantage of the computer's ability to organize and compute large volumes of data. But despite claims made by some software companies, software can't do it all for you. Just like you need to understand your industry, you need to understand the basics of accounting in order to understand its reports and statements.

Accounting is about the destination, we gather the data so we can produce reports that tell us about our companies. It is important to learn how accounting works and how your accounting software works but move away from the details of both as quickly as possible. Use your software and its reports to take a drill down approach focusing first on summaries and then on details.

Accounting reports are meant to keep you on track and to let you know when you need to make course corrections. Before we get into the process of gathering and organizing data, let's take a look at two financial statements the Balance Sheet and Income Statement which we will create in this workbook. Examples of the Balance Sheet and Income Statement are on the next page.

Financial Statements:

The Balance Sheet is like the X on a map that says "You are Here". It tells you what your business owns, what it owes and what it is worth (book value). Items listed on the Balance Sheet have lasting value and they remain on the balance sheet until they are disposed of. Items that do not have lasting value are listed on the Income Statement.

The Income Statement calculates Net Income which is Sales Revenue - Expenses. The Income Statement gives a detailed explanation of how much money you earned and what your costs were. Items listed on the Income Statement do not have lasting value, they are used up within the current business year. Income Statement balances do not carry forward the way Balance Sheet balances do, they are reset and started at zero again at the beginning of each business year. The Income Statement also makes a distinction between the Direct Cost of products and services and the Administrative Cost of running a business. Revenue – Direct Costs = Gross Margin (Profit). Gross Margin – Administrative Costs (Expenses) = Net Income.

Financial Statements Format and Contents

| Balance Sheet | |
|------------------------------|------------|
| December 2010 | |
| Assets | |
| Current Assets | |
| Checking Account | \$550.00 |
| Fixed Assets | |
| Office Equipment | \$225.00 |
| Computer Hardware | \$900.00 |
| Office Furniture | \$945.00 |
| Total Fixed Assets | \$2,070.00 |
| Total Assets | \$2,620.00 |
| Liabilities and Equity | |
| Current Liabilities | |
| Accounts Payable | \$680.00 |
| Total Liabilities | \$680.00 |
| Equity | |
| Owners' Equity | \$2,600.00 |
| Net Income (Loss) | \$(660.00) |
| Total Equity | \$1,940.00 |
| Total Liabilities and Equity | \$2,620.00 |

| Income S | tatement | |
|--------------------------|------------|------------|
| December | r 31, 2010 | |
| Advertising Sales | | \$500.00 |
| Website Hosting | | \$120.00 |
| Gross Margin | _ | \$380.00 |
| Operating Expenses | | |
| Repairs & Maintenance | \$25.00 | |
| Fuel | \$25.00 | |
| Rent | \$500.00 | |
| Office Supplies | \$75.00 | |
| Subscriptions | \$65.00 | |
| Meals | \$45.00 | |
| Phone Service | \$150.00 | |
| Electric Service | \$100.00 | |
| Bank Charges | \$25.00 | |
| Credit Card Interest | \$30.00 | |
| Total Operating Expenses | | \$1,040.00 |
| Net Income(Loss) | | \$(660.00) |

| Balance Sheet Format | | | | |
|---|-----------------------|--|--|--|
| What we have | Assets | What the Business Owns | | |
| = | = Liabilities + | What the Business Owes and must repay | | |
| Where it came from | Equity | What the Business is Worth (What the Business Owners have invested plus Business Net Income) | | |
| Total Assets must equal Total Liabilities plus Equity | | | | |

| | Income Statement Format | | | |
|---|-------------------------|--|--|--|
| + | Revenue | Total Sales Amount | | |
| - | Cost of Goods Sold | What it cost to purchase and/or manufacture products and/or provide services sold | | |
| = | Gross Margin | Amount of Revenue left after direct costs to cover operating expenses | | |
| - | Expenses | Operating Costs Consumed (No lasting Value) | | |
| = | Net Income(Loss) | Profit(Loss) from sales after all consumable costs. Represents the increase or decrease, for the current year, in what the Business is worth | | |

This look at the financial statements we will create is meant to give you a visual representation of where we're going as we progress through the process of gathering and organizing financial data. Let's dig into the gathering and organizing processes now starting with Section 1, Financial Transactions.

Section 1: Financial Transactions

Part 1: Learn to identify transaction elements

The main objective of Double Entry Accounting is to create a balanced financial picture, that is, we should not only know how money was used, we should also know where it came from. We achieve this balance in information through the way we record and organize financial transactions – so it is very important to understand the elements of a financial transaction.

Financial transactions are exchanges of things of value. In order to record a financial transaction, we need to be able to answer these four questions.

- 1. How was the money used? What was either acquired or paid for by this exchange?
- 2. Where did the money come from? What is the source of the money in this exchange?
- 3. What is the dollar value of the exchange?
- 4. When? What is the date of the transaction?

Questions 1 and 2 describe both sides of a transaction, what we did with the money and where the money came from. We cannot record transactions without answers to both of these questions.

Example 1: Wrote a check for \$100

If you only have the information from Example 1 then you know the answers to Questions 2 and 3 but not to Question 1, what did you spend the \$100 on? In order to record a transaction, you need the answer to Question 1 as well. A better description would be:

Example 2: Wrote a check for \$100 for computer repairs.

Example 2 has answered Questions 1, 2 and 3 but not Question 4. In accounting, dates are very important, dates are used to group financial activities together to help understand the profitability of a business and to help in cash management. If I don't know the date of that \$100 check, I won't know when it will be cashed and can't make sure there will be enough money in the bank to cover it.

Example 3: Wrote check #999 dated March 1, 2009 for computer repairs.

Example 3 provides the minimum data required for recording financial transactions. In a real situation, you would also need to know what bank account the check was written from and who it was written to.

Breaking Down Transaction Questions:

To record financial transactions, we need to really understand the elements defined by the four questions. Let's start with some examples of scenarios and answers to the elements defined by Questions one and two:

- 1: How was the money <u>used</u>? What was either <u>acquired</u> or paid for in this exchange?
- 2: Where did the money come from? What is the **source** of the money in this exchange?

For Example 3, the Answers to Question 1 and 2 are:

- 1: Computer Repairs
- 2: Checking Account

In this case, we took money from the Checking Account and used it to pay for Computer Repairs.

The answers to Questions 1 and 2 are not always easy to identify so let's go through a brief explanation for the Acquisition/Use and Source elements of a transaction and then apply the explanations to a few scenarios.

Question 1: Acquisition/Use - How was the money <u>used</u>? What was either a <u>cquired</u> or <u>paid for</u> in this exchange?

Acquisition/Uses are:

- Expenses
- Increases in what you own
- Decreases in what you owe

Expenses:

Consumable item such as Rent, Phone Service, Food or Fuel. Those are short term acquisitions, what you've paid for is used up and may even be used up by the time they are paid for but while they lasted, they belonged to you.

Increases in what you Own:

Increasing what you own is an acquisition: It is easy to identify the acquisition in things you own such as Cash and Assets like Vehicles, Buildings and Equipment.

Decreases in what you Owe:

As I pay off something I owe, like a car loan, that is an acquisition because I have increased my own claim on that car, I own more of it and the bank owns less of it.

Ouestion 2: Source

2: Where did the money come from? What is the source of the money in this exchange?

Sources Are:

- Increases in Income
- Increases in what you Owe
- Decreases in what you Own

Income:

Income is the amount you charge in exchange for your products or services. When you receive a paycheck, the Paycheck is the Acquisition/Use and the *Source* is *Income*.

Increases in What you Owe:

Loans are temporary sources, meaning that eventually you will pay them back. Loans increase when they are Sources, and they decrease when they are Acquisitions/Uses.

Investments into a business by its Owners are Sources. The business essentially *owes* its owners the amount they've invested. In the case of a cash investment, Cash is the Acquisition/Use and the Owner's

Investment (Equity) is the Source. Equity increases when it is a Source.

Decreases in What you Own:

The easiest Source to identify is Cash, we often use cash to pay for the things we buy. Using cash as the Source actually causes a decrease in the things you own – in this case, a decrease in cash. Other things you own can also be used as a Source. If you trade one car for another, at least part of the Source in this case is your original Car.

Scenarios

Let's review the 2 transaction questions that we've covered so far:

- 1: How was the money <u>used</u>? What was either a <u>cquired</u> or paid for in this exchange?
- 2: Where did the money come from? What is the **source** of the money in this exchange?

Transaction Example: November 1, 2010 Paid \$500 to landlord for Rent with Check #100

- 1: Acquisition/Use = Rent
- 2: Source = Checking Account (Check/Cash)

In this case, we took money from the Checking Account and used it to pay Rent.

What if I didn't trade cash for rent, what if I traded accounting services with my landlord in exchange for rent?

- 1: Acquisition/Use = Rent
- 2: Source = Accounting Services (Sales = Income)

In this case, the Acquisition/Use would still be Rent, I still had use of the space for the month, but this time, instead of the Source being the Checking Account, the Source is Accounting Services (Income).

Now lets say another tenant noticed the accounting services and asked me to do some accounting work for her. Let's say the agreement for this work is that she'll pay me in exchange for the work.

- 1: Acquisition/Use = Checking Account (Check/Cash)
- 2: Source = Accounting Services (Sales/Income)

In this case, we earned Money from the Accounting Services Provided

Let's say that I used \$1500 of my own money to open a new checking account for my business.

- 1: Acquisition/Use = Checking Account
- **2: Source** = Owner's Investment (Owner's Equity)

In this case we're recording the Business's transactions, the Business acquired money in the checking account and increased how much investment the owner has in the business.

Identify the Use and the Source for each of these financial transactions.

Table 1: Transactions 1 – 7 occur in November 2010

| Description | Acquisition/Use (Debit) | Source (Credit) |
|--|----------------------------|-----------------|
| Owner invested in the business and deposited \$1500 into the Business Checking Account | | |

| Description | Acquisition/Use (Debit) | Source (Credit) |
|--|----------------------------|-----------------|
| 2. Paid Rent of \$500 with Check #100 | | |
| 3. Bought Office Phone/Fax for \$75 with Check #101 | | |
| 4. Used check #102 to buy new Printer for \$150 | | |
| 5. Bought \$75 of Office Supplies with Check #103 | | |
| 6. Bought \$500 in parts for Server with Check #104 | | |
| 7. Bank Charges of \$10 deducted from Checking Account | | |

All of the transactions to this point have been cash transactions but a common event is to receive goods or services "on account" or "on credit". In that case, we record the receipt of goods and services when we are billed for them.

- 1. Receive the goods or services on account no entry recorded
- 2. Receive a bill for the goods or services record receipt of Goods or Services and the Obligation to Pay (Accounts Payable).
 - Acquisition/Use = Goods or Services
 - **Source** = Accounts Payable
- 3. Pay the bill record Payment of Accounts Payable
 - **Acquisition/Use** = Accounts Payable (Decrease what I owe)
 - Source = Checking Account

Sometimes, we are *providing* the goods or services on "account" or "credit".

- 1. Provide the goods or services on account no entry recorded
- 2. Send a bill for the goods or services record the Sale of Goods or Services and record our customer's Obligation to Pay us (Accounts Receivable).
 - Acquisition/Use = Accounts Receivable
 - **Source** = Sale/Income
- 3. Receive payment for the bill record Cash Receipt for Payment of Accounts Receivable
 - Acquisition/Use = Checking Account (Check/Cash)
 - Source = Accounts Receivable (decrease what I own)

^{*}Recording of Sales can be more complex than the scope of this workbook section, I discuss additional issues involved including Inventory, Cost of Goods Sold and Revenue Recognition at the end of the workbook and on my site http://www.accountingunplugged.com

Table 2: Transactions 8 – 16 of Table 2 occur in December 2010

| Description | Acquisition/Use | Source |
|---|------------------|--------|
| 8. Owner invested another \$1100 and deposited it into Checking Account | | |
| 9. Bought \$700 Office Chair with Check #105 | | |
| 10. Had car's Oil Changed for \$25 – used Check #106 | | |
| 11. Deposited \$500 check for providing Advertising Space on site into Checking Account | | |
| 12. Received \$150 Phone Bill | | |
| 13. Received \$100 Electric Bill | | |
| 14. Received Credit Card Statement \$930 – additional entries below (prior to #15): Credit Card Interest and Fees \$ 30 | | |
| Office Desk \$245 | | |
| • Fuel \$25 | | |
| Business Magazines \$65 | | |
| Business Lunch \$45 | | |
| Website Hosting \$120 | | |
| Server Parts \$400 | | |
| 15. Paid \$500 on Credit Card with Check #107 | Accounts Payable | |
| 16. Bank Charges of \$15 deducted from Checking Account | | |

Answers: Don't be concerned if your wording is a little different from mine as long as it is similar. For example, you might have used "cash" rather than "checking account", or if you used "Income" rather than "Sales" don't worry we'll cover those issues as we continue through the workbook.

Table 1: Transactions 1 – 7 occur in November 2010

| Descrip | otion | Acquisition/Use | Source |
|---------|--|------------------|------------------|
| 1. | Owner invested in the business and deposited \$1500 into the Business Checking Account | Checking Account | Owner Investment |
| 2. | Paid Rent of \$500 with Check #100 | Rent | Checking Account |
| 3. | Bought Office Phone/Fax for \$75 with Check #101 | Phone/Fax | Checking Account |
| 4. | Used check #102 to buy new Printer for \$150 | Printer | Checking Account |
| 5. | Bought \$75 of Office Supplies with Check #103 | Office Supplies | Checking Account |
| 6. | Started building Server (Computer), bought \$500 in parts with Check #104 | Server Parts | Checking Account |
| 7. | Bank Charges of \$10 deducted from Checking Account | Bank Charges | Checking Account |

Table 2: Transactions 8 – 16 of Table 2 occur in December 2010

| Descrip | tion | Acquisition/Use | Source | |
|---------|---|-------------------------------|--------------------|--|
| 8. | Owner invested another \$1100 and deposited it into Checking Account | Checking Account | Owner Investment | |
| 9. | Bought \$700 Office Chair with Check #105 | Office Chair | Checking Account | |
| 10. | Had car's Oil Changed for \$25 – used Check #106 | Oil Change | Checking Account | |
| 11. | Deposited \$500 check for providing Advertising on site into Checking Account | Checking Account | Advertising Income | |
| 12. | Received \$150 Phone Bill | Phone Service | Accounts Payable | |
| 13. | Received \$100 Electric Bill | Electric Service | Accounts Payable | |
| 14. | Received Credit Card Statement \$930 – additional entries shown prior to #15: Credit Card Interest and Fees \$ 30 | Credit Card Interest and Fees | Accounts Payable | |
| • | Office Desk \$245 | Office Desk | Accounts Payable | |
| • | Fuel \$25 | Fuel | Accounts Payable | |
| • | Business Magazines \$65 | Magazines | Accounts Payable | |
| • | Business Lunch \$45 | Lunch | Accounts Payable | |
| • | Website Hosting \$120 | Internet Service | Accounts Payable | |
| • | Server Parts \$400 | Server Parts | Accounts Payable | |
| 15. | Paid \$500 on Credit Card with Check #107 | Accounts Payable | Checking Account | |
| 16. | Bank Charges of \$15 deducted from Checking Account | Bank Charges | Checking Account | |

Section 1 Financial Transactions

Part 2 – Journal Entries

Record Financial Transactions

We've been using substituting "Acquisition/Use" for the Accounting term "Debit" and "Source" for the Accounting term "Credit". Moving forward, we'll use the accounting terminology. Just remember that Debit always means "Acquisition/Use" and Credit always means "Source". No exceptions.

Do not let your prior experiences with the terminology get your way when recording transactions. We are conditioned by banks to think that a debit to our bank account means that our bank account is *decreasing* and I've just told you that a debit is an Acquisition, that your bank account *increases* with a debit. The banks aren't wrong, they're just telling us how a debit affects *their* accounting, not *ours*. Essentially, through our interactions with banks and other businesses, we have learned accounting backwards. Try to set aside your prior experiences and focus on the guidelines I've provided to you.

Now that you have some practice identifying Debits(acquisition/use) and Credits(source), we can move forward and record our transactions by creating journal entries from the transactions in Tables 1 and 2.

Let's review the four questions that much be answered for each transaction. They are:

- 1: How was the money used? What was either Acquired or paid for by this exchange? (Debit description)
- 2: Where did the money come from? What is the source for this exchange? (Credit description)
- **3:** What is the dollar value of the exchange?
- **4:** When? What is the date of the transaction?

The answers for each of these questions are recorded in a journal, hence the term "journal entry". Accounting Journals are grids of rows and columns. For the purpose of this exercise, we'll use five columns, the columns from left to right are Date, Description, Transaction Reference Number, a numeric column for Debit Amounts and a numeric column for Credit Amounts. The left numeric column is always the Debit Column and the right numeric column is always the Credit Column.

For this exercise we'll only use the month and year for the date for Question 4. For readability purposes only, in accounting journals that are written by hand, the Date and the Transaction Reference # are only entered on the first row of the transaction and Question 1 is answered before Question 2.

I'm not trying to spring anything new on you here, the reference number is really just an incremental numbering system used for tracking purposes in ledgers. We'll make use of the reference numbers when we create our general ledger. It's just a simple system of 1 for the first transaction, 2 for the second etc...

Example 4: Transaction # 1

Answer 1: The money was deposited into the Checking Account.

Answer 2: The money came from the Owner.

Answer 3: \$1,500

Answer 4: November, 2010

| Date | Description | Ref | Debit | Credit |
|----------|--|-----|------------|------------|
| Nov/2010 | Checking Account | 1 | \$1,500.00 | |
| | Owner Investment | | | \$1,500.00 |
| | *Deposited \$1500 from owner into checking account | | | |

*A description is often added below the transaction for clarity in future reviews

As you can see, the amount from Question 3 has been entered twice (double entry), once in the Debit Column and once in the Credit Column. This is the double entry method and it creates a balanced picture of a business - associating dollar values to the answers to both questions 1 and 2. If you have answered all four questions for each transaction and the Debit and Credit columns always add up to the same number, your books are in balance. This brings us to the most basic rule of accounting.

• Total Debits must always equal Total Credits

How to handle more than one answer for Question 1 or 2

In the previous example the transaction was very simple, there was a \$1,500 transfer from the Owner to the Business Checking Account. In that case, there was only one answer each for questions 1 and 2. Sometimes there is more than one answer to one or both of those questions. In those cases, multiple lines may be used and the dollar amounts must be split up for each answer. For example, in the case of a credit card statement there can be many different types of charges on one statement. You have already seen an example of this in the first exercise, now we'll see how the journal entry looks for multiple line answers.

In this case, since there are multiple answers for Question 1, the descriptions and the amounts related to each separate part of the answer are listed on separate lines but the total of the amounts associated with Question 1 and with Question 2 will always be equal, fulfilling the requirement that Total Debits = Total Credits.

• Example 5: Transaction 299, Credit Card Statement for December 2010, Total Due = \$150.00 (individual charges are listed separately and include 75.00 for Office Supplies etc... as seen below)

| Date | Description | Ref | Debit | Credit |
|----------|---------------------------------|-----|---------|----------|
| Dec/2010 | Office Supplies | 299 | \$75.00 | |
| | Fuel | | \$25.00 | |
| | Magazine Subscription | | \$50.00 | |
| | Accounts Payable | | | \$150.00 |
| | *Credit Card Statement Dec/2010 | | | |

Totals: \$150.00 \$150.00

Practice: Create the Journal Entries

Create Journal Entries for the transactions 1-16 in Tables 1 and 2 from our first exercise in the grid below. Add the transaction reference number in the "Ref" column. This will be important later when we transfer our entries to the General Ledger.

| Date | Description | Ref | Debit | Credit |
|----------|--|-----|------------|------------|
| Nov/2010 | Checking Account | 1 | \$1,500.00 | |
| | Owner's Investment | | | \$1,500.00 |
| | *Deposited \$1500 from owner into checking account | | | |
| Nov/2010 | Rent | 2 | | |
| | | | | |
| | | | | |

| Date | Description | Ref | Debit | Credit |
|------|-------------|-----|-------|--------|
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| Date | Description | Ref | Debit | Credit |
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Answers

| Date | Description | Ref | Debit | Credit |
|-----------|--|-----|------------|------------|
| Nov/2010 | Checking Account | 1 | \$1,500.00 | |
| | Owners Investment | | | \$1,500.00 |
| | | | | |
| Nov/2010 | Rent | 2 | \$500.00 | |
| | Checking Account (Check 100) | | | \$500.00 |
| | | | | |
| Nov/2010 | Office Phone/Fax | 3 | \$75.00 | |
| | Checking Account (Check 101) | | | \$75.00 |
| Nov/2010 | Printer | 4 | \$150.00 | |
| | Checking Account (Check 102) | | | \$150.00 |
| Nov/2010 | Office Cymplics | 5 | \$75.00 | |
| NOV/2010 | Office Supplies Chapting Account (Chapte 102) | 5 | \$75.00 | \$75.00 |
| | Checking Account (Check 103) | | | \$75.00 |
| Nov/2010 | Server Parts | 6 | \$500.00 | |
| | Checking Account (Check 104) | | | \$500.00 |
| Nov/2010 | Bank Charges | 7 | \$10.00 | |
| 1101/2010 | Checking Account | , | ψ10.00 | \$10.00 |
| | | | | |
| | November Totals | | \$2,810.00 | \$2,810.00 |
| Dec/2010 | Checking Account | 8 | \$1,100.00 | |
| | Owner's Investment | | . , | \$1,100.00 |
| Dec/2010 | Office Chair | 9 | \$700.00 | |
| Dec/2010 | | 9 | \$700.00 | \$700.00 |
| | Checking Account (Check 105) | | | \$700.00 |
| Dec/2010 | Oil Change | 10 | \$25.00 | |
| | Checking Account (Check 106) | | | \$25.00 |
| Dec/2010 | Checking Account | 11 | \$500.00 | |
| 2010 | Advertising Sales | 11 | ψ500.00 | \$500.00 |
| | | | | 4200.00 |

| Date | Description | Ref | Debit | Credit |
|----------|-------------------------------------|-----|-------------------|-------------------|
| Dec/2010 | Phone Service | 12 | \$150.00 | |
| | Accounts Payable (Phone Company) | | | \$150.00 |
| | | | | |
| Dec/2010 | Electric Service | 13 | \$100.00 | |
| | Accounts Payable (Electric Company) | | | \$100.00 |
| Dec/2010 | Credit Card Interest and Fees | 14 | \$30.00 | |
| | Office Desk | | \$245.00 | |
| | Fuel | | \$25.00 | |
| | Magazine Subscription | | \$65.00 | |
| | Business Lunch | | \$45.00 | |
| | Website Hosting | | \$120.00 | |
| | Server Parts | | \$400.00 | |
| | Accounts Payable (Credit Card) | | | \$930.00 |
| Dec/2010 | Accounts Payable (Credit Card) | 15 | \$500.00 | |
| | Checking Account (Check 107) | | | \$500.00 |
| Dec/2010 | Bank Charges | 16 | \$15.00 | |
| | Checking Account | | | \$15.00 |
| | December Totals | | \$4,020.00 | <i>\$4,020.00</i> |
| | Grand Totals | | <u>\$6,830.00</u> | <u>\$6,830.00</u> |

Congratulations! If you've made it this far and your numbers match the answers, you have successfully created the journal entries for each of our transactions *and* your total debits and credits are equal! By just answering the Four Transaction Questions, you can keep an accurate accounting of your financial transactions.

Journal entries gather great information but they don't really tell you anything by themselves. Our next step is to organize our transactions and post them into a ledger to make our journal entries meaningful. The rest is all about arranging our journal entries by description (account) and date.

Section 2: Organize Financial Transactions Make Sense of the Journal Entries

Part 1: Create a Chart of Accounts

The first step to take in organizing journal entries is to make a list of the descriptions we used in answering Questions 1 and 2. That list will be called our Chart of Accounts. Don't let the terminology get in the way, the Chart of Accounts *really is* just a list of transaction descriptions.

Let's start with the list of descriptions we've already generated. Remember that we did not create this list first, we just added descriptions as new things happened. It is most common for an accountant to set up the Chart of Accounts ahead of time and then add to it as needed but that is not required, you can just create the list as you are recording journal entries. Once the Chart of Accounts has been started though, make sure to check for existing descriptions that might fit when recording journal entries so you don't create duplicates.

List of Descriptions from transaction Questions 1 and 2

- Checking Account
- Owner's Investment
- Rent
- Office Phone/Fax
- Printer
- Office Supplies
- Server Parts
- Bank Charges
- Office Chair
- Oil Change
- Advertising Sales
- Phone Service
- Accounts Payable
- Electric Service
- Credit Card Interest and Fees
- Office Desk
- Fuel
- Magazine Subscription
- Business Lunch
- Website Hosting

This list of descriptions is our Chart of Accounts. Each description in the list is an Account in the Chart of Accounts. The next step to take in creating our Chart of Accounts is to edit it a little bit.

To keep the Chart of Accounts meaningful it is important to strike a balance between having a long specific list and a short general list. You want the Accounts to be specific enough to be useful but not too specific because the fewer accounts you have the better overall picture you get from financial reports. To accomplish this objective, a good rule of thumb is that the Chart of Accounts should have accounts for *types* of things, and not for specific things.

Let's edit our list a little bit. Group accounts together with more general descriptions where it makes sense to do so. For example, you wouldn't add individual accounts for paper, pens and staples, you would just use one account called Office Supplies. Another example might be to use Office Furniture as an account rather than separating the chair and desk.

From the transactions in the Tables 1 and 2, we have started a Chart of Accounts. Column 1 is the list of accounts generated from the transactions. In Column 2, we combine some accounts and make the descriptions more general and in Column 3, we eliminate duplicates.

| Original Descriptions | Revised | Chart of Accounts |
|-------------------------------|-------------------------------|-------------------------------|
| Checking Account | Checking Account | Checking Account |
| Owner's Investment | Owners' Equity | Owners' Equity |
| Rent | Rent | Rent |
| Office Phone/Fax | Office Equipment | Office Equipment |
| Printer | Office Equipment | |
| Office Supplies | Office Supplies | Office Supplies |
| Server Parts | Computer Hardware | Computer Hardware |
| Bank Charges | Bank Charges | Bank Charges |
| Office Chair | Office Furniture | Office Furniture |
| Oil Change | Repairs and Maintenance | Repairs and Maintenance |
| Advertising Sales | Advertising Sales | Advertising Sales |
| Phone Service | Phone Service | Phone Service |
| Accounts Payable | Accounts Payable | Accounts Payable |
| Electric Service | Electric Service | Electric Service |
| Credit Card Interest and Fees | Credit Card Interest and Fees | Credit Card Interest and Fees |
| Office Desk | Office Furniture | |
| Fuel | Fuel | Fuel |
| Magazine Subscription | Subscriptions | Subscriptions |
| Business Lunch | Meals | Meals |
| Website Hosting | Website Hosting | Website Hosting |

Section 2 Part 2: Create a General Ledger

Now that we have created the Chart of Accounts we can use it to make sense of our journal entries. To do this we will transfer our journal entries into our General Ledger. The General Ledger reorganizes journal entries and sorts them by Account rather than by Journal Entry transaction number.

Example 6 below illustrates the difference between the general journal and the general ledger.

Example 6:

| General Journal | | | | | | |
|-----------------|------------------|-----|------------|------------|--|--|
| Date | Description | Ref | Debit | Credit | | |
| Nov/2010 | Checking Account | 1 | \$1,500.00 | | | |
| | Owner Investment | | | \$1,500.00 | | |
| Nov/2010 | Rent | 2 | \$500.00 | | | |
| | Checking Account | | | \$500.00 | | |

| General Ledger | | | | | |
|----------------|------------------|-----|------------|----------|------------|
| Account: | Checking Account | | | | |
| Date | Description | Ref | Debit | Credit | Balance |
| Nov/2010 | Owner Investment | 1 | \$1,500.00 | | \$1,500.00 |
| Nov/2010 | Rent, Check#100 | 2 | | \$500.00 | \$1,000.00 |
| | | | | | |

In a hand written General Ledger each account has its own page(s) where all entries for that account are listed and a running balance is kept. Notice that the debits and credits do not balance for the General Ledger Account "Checking Account". This is because we're only looking at part of each journal entry when we're looking at a specific general ledger account. Notice how the Ref fields for both the journal and the ledger correspond to each other, if I look for Ref 1 in the journal, I can see the entire entry rather than just the part that relates to the Checking Account.

Rather than create a page here for each account in our general ledger, we'll use a visual tool used by many accountants called a T-Account. It's called a T-Account because you just draw a T, put the account title on top and use the space left of the mid line to record debits and the space to the right of the mid line to record credits.

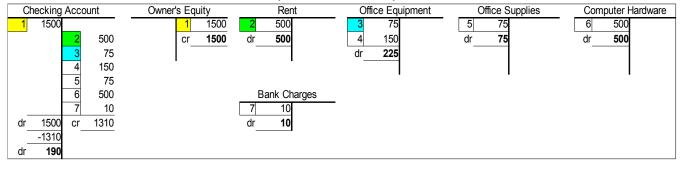
You can create your own general ledger account pages by following the format below or you can just use T-Accounts. I will provide the solutions to the T-Accounts as we go but I will provide the General Ledger Accounts and their balances at the end of the workbook.

| T-ACCOUNT | | | | |
|------------------|--|--|--|--|
| Checking Account | | | | |
| | | | | |
| | | | | |
| | | | | |

| General Ledger | | | | | | |
|----------------|------------------------------|-----|------------|----------|---------------|-----------------|
| Account: | Checking Account | | | | | |
| Date | Description | Ref | Debit | Credit | Month Balance | Account Balance |
| Nov/2010 | Owner Investment | 1 | \$1,500.00 | | \$1,500.00 | \$1,500.00 |
| Nov/2010 | Rent, Check#100 | 2 | | \$500.00 | \$1,000.00 | \$1,000.00 |
| Nov/2010 | Office Phone/Fax, Check #101 | 3 | | \$75.00 | \$925.00 | \$925.00 |

A note about running balances in General Ledger Accounts. Debit entries are added to the balance and credit entries are subtracted from the balance. The purpose of adding and subtracting is really just to find the difference between debits and credits to come to a balance. Positive balances are "Debit Balances" and negative balances are "Credit Balances". Don't get caught up in the meaning of the positive or negative running balances. We'll discuss that further once we've created the T-Accounts and their entries.

T-Accounts for November Transactions (1-7 from Table 1)



T-Accounts are a compact and easy way to view the effects of transactions on multiple accounts. In these examples, I've recorded the debits and the credits for the transactions from Table 1 along with a transaction number (highlighted for the first three entries) so that I can trace and verify the entries by transaction number.

The account balance is the **difference** between debits and credits. Total all entries for each column in the T-Account and subtract the smallest total from the largest. If the debits are higher the ending balance will be a debit balance and if the credits are higher the ending balance will be a credit balance. On the lines that represent the totals, I put either a "dr" for debit or a "cr" for credit to highlight whether the ending balance was a debit or a credit balance.

Trial Balance for November 2010

Once we've completed the entries in the T-Accounts and calculated the balances for each account, we can create a summary of the accounts and their balances. This summary is called the Trial Balance. The Trial Balance is formated in a grid similar to the Journal Entry grid. The columns of the Trial Balance shown below should look familiar to you. Now though, instead of listing each transaction separately into the grid, we list the Accounts and their balances as of the Trial Balance date.

| Trial Balance at Nov. 30, 2010 | | | | | |
|--------------------------------|------------|------------|--|--|--|
| Account | Debit | Credit | | | |
| Checking Account | 190.00 | | | | |
| Office Equipment | 225.00 | | | | |
| Computer Hardware | 500.00 | | | | |
| Owners' Equity | | 1500.00 | | | |
| Rent | 500.00 | | | | |
| Office Supplies | 75.00 | | | | |
| Bank Charges | 10.00 | | | | |
| Totals | \$1,500.00 | \$1,500.00 | | | |

The Trial Balance, gives you a much better picture of the impact of your financial transactions for the month. Notice, that total debits still equal total credits.

Notice that the Owners Equity Account has a credit balance. If I were calculating the balance in a ledger, I would have *subtracted* the \$1500 entry from zero and ended up with a negative balance. This doesn't mean that the owners have negative equity in their company, it is only a way to indicate that the balance is a credit balance.

Types of accounts that should have credit balances are accounts that *increase* when they are used as the *Source* side of the transaction's journal entry. Types of accounts that increase when they are used as Source Accounts are **Purchases on Account or Credit, Loans, Investments into the company by its owners** and **Income**. For example, Accounts Payable is a source account type, so I would expect it to have a credit balance. If it has a debit balance, that means that I have over-paid an account.

Types of accounts that should have debit balances are accounts that *increase* when they are used as the *Acquisition/Use* side of the transaction's journal entry. Types of accounts that increase when they are used as Acquisition/Use Accounts are **Assets** (what you own), **Costs** and **Expenses** (both are consumable items). For example, the checking account is an Asset - something I own – type of account so I would expect for it to have a debit balance, if it has a credit balance, that means I am overdrawn.

It is important to identify accounts by their Acquisition/Use or Source classifications and watch their balances to make sure they have the correct debit or credit balances. In the Trial Balance above, all of the account balances are either debit or credit as would be expected by their classifications.

Debit/Credit Classifications for the Accounts used in the November transactions

| Account | Debit | Credit | Increases as | Classification / Expected Balance | More Description |
|-------------------|--------|---------|-----------------|--------------------------------------|--------------------------------|
| Checking Account | 190.00 | | Acquisition/Use | Debit | Something the business owns |
| Office Equipment | 225.00 | | Acquisition/Use | Debit | Something the business owns |
| Computer Hardware | 500.00 | | Acquisition/Use | Debit | Something the business owns |
| Owners' Equity | | 1500.00 | Source | Credit | Owners Investment into Company |
| Rent | 500.00 | | Acquisition/Use | Debit | Consumable (Acquisition/Use) |
| Office Supplies | 75.00 | | Acquisition/Use | Debit | Consumable (Acquisition/Use) |
| Bank Charges | 10.00 | | Acquisition/Use | Debit | Consumable (Acquisition/Use) |
| | | | | | |

For the next exercise, fill out the T-Accounts provided on the next page with the transactions for December 2010 from Table 2.

I am only asking for the December entries here because it is very useful to group transactions not only by account but also by time periods. In accounting, months are the common period of time for grouping transactions.

After you have created the T-Account entries and calculated the account balances, enter the totals for December into the December Trial Balance form on the page that follows the T-Accounts. Make sure that the total debits and credits for all entries are equal. Once you've completed the December Trial Balance, combine the November and December totals for each account and enter them into the Cumulative Trial Balance. I have included a form for a comparative trial balance, you can fill in the December amounts for it as well, making sure that accounts with Credit balances are entered as negative amounts and that the totals at the bottom are equal to zero.

Create entries in the T-Accounts for the December transactions from Tables 1 and 2.

| Checking Account | Owner's Equity | Computer Hardware | Bank Charges |
|------------------|-----------------------|-------------------|------------------|
| | | | |
| | | | |
| | | | |
| Office Furniture | Repairs & Maintenance | Sales | Accounts Payable |
| | | | |
| | | | |
| Phone Service | Electric Service | Credit Card Fees | Fuel |
| | | | |
| Subscriptions | Meals | Website Hosting | |
| | | | |

T-Accounts for December Transactions:

| Checking Account | Owner's Equity | Computer Hardware | Bank Charges |
|---|---|-------------------------|-------------------------------|
| 1 1100 2 700 3 25 4 500 8 500 9 15 dr 1600 -1240 dr \$360 | 1 <u>1100</u> cr <u>\$1,100</u> | 7400 dr \$400 | 9 <u>15</u> dr \$15 |
| Office Furniture | Repairs & Maintenance | Sales | Accounts Payable |
| 2 700 | 3 25 | 4 500 | 5 150 |
| 7245 | dr \$25 | cr \$500 | 6 100 |
| dr \$945 | | | 7 930 |
| | | | 8 500 |
| | | | dr 500 cr 1180 |
| | | | -500 cr \$680 |
| I | I | I | CI <u> </u> |
| Phone Service | Electric Service | Credit Card Fees | Fuel |
| 5150 | 6100 | 730 | 725 |
| dr \$150 | dr \$100 | dr \$30 | dr \$25 |
| | | | |
| Subscriptions | Meals | Website Hosting | |
| 765 | 745 | 7120 | |
| dr \$65 | dr \$45 | dr \$120 | |
| | | | |
| I | I | I | I |

Create your Own Trial Balance for December from the T-Account Balances

Trial Balance for November Transactions only

| Account | Debit | Credit |
|-------------------|------------|------------|
| | | |
| Checking Account | 190.00 | |
| Office Equipment | 225.00 | |
| Computer Hardware | 500.00 | |
| Owners' Equity | | 1500.00 |
| Rent | 500.00 | |
| Office Supplies | 75.00 | |
| Bank Charges | 10.00 | |
| | | |
| Totals | \$1,500.00 | \$1,500.00 |

Trial Balance for December Transactions only

| Account | Debit | Credit |
|------------------------|-------|--------|
| | | |
| Checking Account | | |
| Office Equipment | | |
| Computer Hardware | | |
| Office Furniture | | |
| Accounts Payable | | |
| Owners' Equity | | |
| Sales | | |
| Website Hosting | | |
| Repairs & Maintenance | | |
| Fuel | | |
| Subscriptions | | |
| Meals | | |
| Phone Service | | |
| Electric Service | | |
| Office Supplies | | |
| Bank Charges | | |
| Credit Card Fees & Int | | |
| Totals | | |

Combine the Account Balances for November and December and Create a Trial Balance for Dec. 31.

Cumulative Trial Balance at Dec. 31, 2010

| Account | Debits | Credits |
|------------------------|--------|---------|
| | | |
| Checking Account | | |
| Office Equipment | | |
| Computer Hardware | | |
| Office Furniture | | |
| Accounts Payable | | |
| Owners' Equity | | |
| Sales | | |
| Website Hosting | | |
| Rent | | |
| Repairs & Maintenance | | |
| Fuel | | |
| Subscriptions | | |
| Meals | | |
| Phone Service | | |
| Electric Service | | |
| Office Supplies | | |
| Bank Charges | | |
| Credit Card Fees & Int | | _ |
| | | |
| Totals | | |

Comparative Trial Balance at Dec. 31, 2010

| Account | November | December | Total |
|------------------------|----------|----------|-------|
| Checking Account | 190.00 | | |
| Office Equipment | 225.00 | | |
| Computer Hardware | 500.00 | | |
| Office Furniture | 0.00 | | |
| Accounts Payable | 0.00 | | |
| Owners' Equity | -1500.00 | | |
| Sales | 0.00 | | |
| Website Hosting | 0.00 | | |
| Rent | 500.00 | | |
| Repairs & Maintenance | 0.00 | | |
| Fuel | 0.00 | | |
| Subscriptions | 0.00 | | |
| Meals | 0.00 | | |
| Phone Service | 0.00 | | |
| Electric Service | 0.00 | | |
| Office Supplies | 75.00 | | |
| Bank Charges | 10.00 | | |
| Credit Card Fees & Int | 0.00 | | |
| Totals | \$0.00 | \$0.00 | 0.00 |

Trial Balance for November Transactions only

| Account | Debit | Credit |
|-------------------|------------|------------|
| Checking Account | 190.00 | |
| Office Equipment | 225.00 | |
| Computer Hardware | 500.00 | |
| Owners' Equity | | 1500.00 |
| Rent | 500.00 | |
| Office Supplies | 75.00 | |
| Bank Charges | 10.00 | |
| Totals | \$1,500.00 | \$1,500.00 |

Trial Balance for December Transactions only

| Account | Debit | Credit |
|------------------------|------------|------------|
| Checking Account | 360.00 | |
| Office Equipment | 0.00 | |
| Computer Hardware | 400.00 | |
| Office Furniture | 945.00 | |
| Accounts Payable | | 680.00 |
| Owners' Equity | | 1100.00 |
| Sales | | 500.00 |
| Website Hosting | 120.00 | |
| Repairs & Maintenance | 25.00 | |
| Fuel | 25.00 | |
| Subscriptions | 65.00 | |
| Meals | 45.00 | |
| Phone Service | 150.00 | |
| Electric Service | 100.00 | |
| Office Supplies | | |
| Bank Charges | 15.00 | |
| Credit Card Fees & Int | 30.00 | |
| Totals | \$2,280.00 | \$2,280.00 |

Cumulative Trial Balance at December 31

| Account | Debits | Credits |
|------------------------|------------|------------|
| | 550.00 | |
| Checking Account | 550.00 | |
| Office Equipment | 225.00 | |
| Computer Hardware | 900.00 | |
| Office Furniture | 945.00 | |
| Accounts Payable | | 680.00 |
| Owners' Equity | | 2600.00 |
| Sales | | 500.00 |
| Website Hosting | 120.00 | |
| Rent | 500.00 | |
| Repairs & Maintenance | 25.00 | |
| Fuel | 25.00 | |
| Subscriptions | 65.00 | |
| Meals | 45.00 | |
| Phone Service | 150.00 | |
| Electric Service | 100.00 | |
| Office Supplies | 75.00 | |
| Bank Charges | 25.00 | |
| Credit Card Fees & Int | 30.00 | |
| Totals | \$3,780.00 | \$3,780.00 |

Comparative Trial Balance at December 31

| Account | November | December | Total |
|------------------------|----------|----------|----------|
| Checking Account | 190.00 | 360.00 | 550.00 |
| Office Equipment | 225.00 | 0.00 | 225.00 |
| Computer Hardware | 500.00 | 400.00 | 900.00 |
| Office Furniture | 0.00 | 945.00 | 945.00 |
| Accounts Payable | 0.00 | -680.00 | -680.00 |
| Owners' Equity | -1500.00 | -1100.00 | -2600.00 |
| Sales | 0.00 | -500.00 | -500.00 |
| Website Hosting | 0.00 | 120.00 | 120.00 |
| Rent | 500.00 | 0.00 | 500.00 |
| Repairs & Maintenance | 0.00 | 25.00 | 25.00 |
| Fuel | 0.00 | 25.00 | 25.00 |
| Subscriptions | 0.00 | 65.00 | 65.00 |
| Meals | 0.00 | 45.00 | 45.00 |
| Phone Service | 0.00 | 150.00 | 150.00 |
| Electric Service | 0.00 | 100.00 | 100.00 |
| Office Supplies | 75.00 | 0.00 | 75.00 |
| Bank Charges | 10.00 | 15.00 | 25.00 |
| Credit Card Fees & Int | 0.00 | 30.00 | 30.00 |
| Totals | \$0.00 | \$0.00 | 0.00 |

Comparative Trial Balance:

Notice how the use of negative balances in the Comparative Trial Balance replaces the need for using separate debit and credit columns. Notice also that the totals for each of its columns are zero. Debits – Credits = 0 is the same as Debits = Credits. This format enables the user to quickly compare monthly account activity in a compact format. Comparing Account activity from month to month is a quick way to identify potential problems. In this case, I can quickly see that there is no Rent expense recorded for December and perhaps I should investigate that further.

Section 3 – Financial Statements

Congratulations on making it this far, hang in there, this is the final section. In this section we'll create and analyze Financial Statements. We've already covered the Trial Balance so the financial statements we'll cover in this section are the Balance Sheet and the Income Statement. Before we can create financial statements though, we need to put our Accounts into a standard order. *The sorting standards I present here are standard for the United States.

Part 1: Organizing the Chart of Accounts

Accounts for the Financial Statements are organized in very specific order so before we can produce and analyze the statements, we need to understand how to organize our Chart of Accounts.

The Chart of Accounts is organized using three different methods.

- First: Accounting Types
- Second: Order of Liquidity the ease of converting to cash without loss of value
- Third: Account Numbers

Accounting Types:

The 7 Basic Accounting Types (In order) Are:

- Assets *Things you own
- Liabilities Things you owe
- Equity Owners Stake in Company
- Revenue Income through Sales of the Services or Products of the Business
- Costs of Goods Sold Costs to provide the service or to manufacture or acquire the product the business sells
- Expenses *Operating costs, these have no lasting value but are part of the cost of running a business
- Other Revenue and Expenses Revenue and Expenses that are unusual cases and are not directly related to the business product and are not usual costs of running a business
 - * The cost of an item will sometimes cause it to be classified as an expense rather than as an asset. For concept purposes, we will discuss the cost exception at a later point with the discussion on depreciation.

Costs and Expenses are very similar and at this point if you aren't sure whether something is a Cost or an Expense, classify it as an Expense. The difference between Costs and Expenses can only be determined if you know what the business "does for a living" what does it sell? If you know what the business sells, you will be able to determine what the costs of that product or service are.

In the case of our example business, the business is selling advertising space on its website. The owner creates the web pages and is not collecting a salary at this time. The software to create the web pages is provided for free so the only direct costs for the product are Website Hosting costs.

Exercise – Practice Identifying Accounting Types

Let's take a look at our Chart of Accounts in its original order. Try to Identify the Accounting Type for each Account.

| Account | Accounting Type |
|-------------------------------|-----------------|
| Checking Account | |
| Owners' Equity | |
| Office Equipment | |
| Office Supplies | |
| Computer Hardware | |
| Bank Charges | |
| Office Furniture | |
| Repairs and Maintenance | |
| Advertising Sales | |
| Phone Service | |
| Accounts Payable | |
| Electric Service | |
| Credit Card Interest and Fees | |
| Fuel | |
| Subscriptions | |
| Meals | |
| Website Hosting | |

Solutions: Accounting Types

| Account | Accounting Type |
|-------------------------------|--------------------|
| Checking Account | Asset |
| Owners' Equity | Equity |
| Office Equipment | Asset |
| Office Supplies | Expense |
| Computer Hardware | Asset |
| Bank Charges | Expense |
| Office Furniture | Asset |
| Repairs and Maintenance | Expense |
| Advertising Sales | Expense |
| Phone Service | Expense |
| Accounts Payable | Liability |
| Electric Service | Expense |
| Credit Card Interest and Fees | Expense |
| Fuel | Expense |
| Subscriptions | Expense |
| Meals | Expense |
| Website Hosting | Cost of Goods Sold |

Now that the accounting type has been identified for each Account, let's rearrange the the Accounts in Accounting Type Order.

| Account | Accounting Type |
|-------------------------------|--------------------|
| Checking Account | Asset |
| Office Equipment | Asset |
| Computer Hardware | Asset |
| Office Furniture | Asset |
| Accounts Payable | Liability |
| Owners' Equity | Equity |
| Advertising Sales | Revenue |
| Website Hosting | Cost of Goods Sold |
| Office Supplies | Expense |
| Electric Service | Expense |
| Phone Expense | Expense |
| Meals | Expense |
| Subscriptions | Expense |
| Bank Charges | Expense |
| Credit Card Interest and Fees | Expense |
| Repairs and Maintenance | Expense |
| Fuel | Expense |

Sorting by Order of Liquidity:

The Chart of Accounts' second method of organization is Order of Liquidity. Order of Liquidity sorting applies to Assets and Liabilities. Cash is the most liquid of all assets and other assets are listed in the order that they can be expected to convert to cash (turnover) at close to their current value.

Accounts are listed in descending order of liquidity within their accounting types, with cash at the top of the list for Assets. Assets and Liabilities are divided into the Subtypes of Current and Fixed/Long Term to group items of similar liquidity together. The "Current" subtype applies to assets and liabilities expected to turnover within ONE year.

The "Current" subtype for Assets and Liabilities is important for two reasons. First, it groups together items with a high turnover rate and second, it provides a quick warning sign for cash management. Current Liabilities are usually paid by Current Assets so having a higher balance in Current Liabilities than in Current Assets is a warning sign — it is not foolproof so use caution when using it as a management tool.

Order of Liquidity Guidelines

| Assets | |
|-----------------------|--|
| Current Assets | |
| Cash | |
| Receivables | |
| Inventory | |
| Fixed Assets | |
| Property | |
| Plant | |
| Equipment | |
| Liabilities | |
| Current Liabilities | |
| Long Term Liabilities | |

Accounts Sorted by Accounting Type and Order of Liquidity

| Account | Accounting Type |
|-----------------------------|--------------------|
| Checking Account | Current Asset |
| Office Equipment | Fixed Asset |
| Computer Hardware | Fixed Asset |
| Office Furniture | Fixed Asset |
| Accounts Payable | Current Liability |
| Owners' Equity | Equity |
| Sales | Revenue |
| Website Hosting | Cost of Goods Sold |
| Repairs & Maintenance | Expense |
| Fuel | Expense |
| Office Supplies | Expense |
| Subscriptions | Expense |
| Meals | Expense |
| Phone Service | Expense |
| Electric Service | Expense |
| Bank Charges | Expense |
| Credit Card Fees & Interest | Expense |

Sorting By Account Numbers:

The Chart of Accounts' final method of organization is Account Numbers. Part of the strength of this method is the ability it provides users to recognize the Accounting Type and in some instances the Order of Liquidity simply by the Account Number assigned to the Account.

Assigning Account numbers starts by assigning a range of numbers to each Accounting Type. The range that I like and use the most is ranges of 1000 (four digits). I like to assign numbers in the thousand ranges because the numbers contain a manageable amount of digits and it is unlikely (in a small to mid-size company) that you'll run out of numbers to use for Accounts. The number of digits will be important in your software system so when using ranges in the 1000's there are 4 digits, and the Account Numbers would range from 1000 to 9999.

It really doesn't matter how you assign ranges as long as you assign them in order by Accounting Type and by order of liquidity and you are consistent but it is important to understand the industry standards for your business prior to assigning number ranges. The reason it is important to understand industry standards is that different industries create their own Subtypes and will have a standard for assigning the number ranges to those Subtypes.

Generally I assign the number ranges in this order:

• **Assets:** 1000's

• Current Assets 1000 - 1499

• Fixed Assets 1500 -1999

• Liabilities: 2000's

• Current Liabilities 2000 - 2499

• Long Term Liabilities 2500 - 2999

Equity: 3000'sRevenue: 4000's

• Costs of Goods Sold: 5000's

• I leave the 6000's open to allow for a Cost of Goods Sold Subtype

Expenses: 7000'sOther Revenue: 8000'sOther Expenses: 9000's

After the initial sorting of Accounts by Accounting Type and Order of Liquidity, Accounts can be sorted and Account Numbers can also be assigned any way you like. When you initially set up your accounts, it is important to use intervals of at least 10 or 20 between similar Accounts. I try to skip to the next 100 for Accounts of different types (if one grouping ended at 7030, I'd start the next grouping at 7100). This strategy gives good clues to the user about the type of account and it allows for the addition of new Accounts later.

The table on the following page gives an example of possible account numbers but as I said, as long as you decide on and follow a system, you can choose how to assign the account numbers.

Sample Chart of Accounts with Account Numbers, Accounting Types and Balances at Dec 31, 2010

| Account # | Account Title | Accounting Type | Debits | Credits |
|-----------|-----------------------------|--------------------|------------|------------|
| 1000 | Checking Account | Current Asset | \$550.00 | |
| 1500 | Office Equipment | Fixed Asset | \$225.00 | |
| 1520 | Computer Hardware | Fixed Asset | \$900.00 | |
| 1540 | Office Furniture | Fixed Asset | \$945.00 | |
| 2000 | Accounts Payable | Current Liability | | \$680.00 |
| 3000 | Owners' Equity | Equity | | \$2,600.00 |
| 4000 | Sales | Revenue | | \$500.00 |
| 5000 | Website Hosting | Cost of Goods Sold | \$120.00 | |
| 7000 | Repairs & Maintenance | Expense | \$25.00 | |
| 7020 | Fuel | Expense | \$25.00 | |
| 7100 | Rent | Expense | \$500.00 | |
| 7120 | Office Supplies | Expense | \$75.00 | |
| 7140 | Subscriptions | Expense | \$65.00 | |
| 7160 | Meals | Expense | \$45.00 | |
| 7200 | Phone Service | Expense | \$150.00 | |
| 7220 | Electric Service | Expense | \$100.00 | |
| 7300 | Bank Charges | Expense | \$25.00 | |
| 7320 | Credit Card Fees & Interest | Expense | \$30.00 | |
| | Totals: | | \$3,780.00 | \$3,780.00 |

Section 3 - Part 2: Create Financial Statements

The standard order for the Chart of Accounts is the order in which the Accounts appear on the Trial Balance, Balance Sheet and Income Statement. The methods of organization are very helpful in managing the accounts but they are essential in providing meaning to our financial statements.

Before we view them separately let's look at the three main financial statements side by side to see how the accounts are reported on each of them. The Trial Balance lists *all* Accounts and then each account is *either* on the Balance Sheet *or* the Income Statement. If an Account is not on the Balance Sheet, it must be on the Income Statement.

| Trial Balance Accounts | | | |
|------------------------|------------------------|---------|---------|
| Accou | nnt | Debits | Credits |
| 1000 | Checking Account | 550.00 | |
| 1500 | Office Equipment | 225.00 | |
| 1520 | Computer Hardware | 900.00 | |
| 1540 | Office Furniture | 945.00 | |
| 2000 | Accounts Payable | | 680.00 |
| 3000 | Owners' Equity | | 2600.00 |
| 4000 | Sales | | 500.00 |
| 5000 | Website Hosting | 120.00 | |
| 7000 | Repairs & Maintenance | 25.00 | |
| 7020 | Fuel | 25.00 | |
| 7100 | Rent | 500.00 | |
| 7120 | Office Supplies | 75.00 | |
| 7140 | Subscriptions | 65.00 | |
| 7160 | Meals | 45.00 | |
| 7200 | Phone Service | 150.00 | |
| 7220 | Electric Service | 100.00 | |
| 7300 | Bank Charges | 25.00 | |
| 7320 | Credit Card Fees & Int | 30.00 | |
| | Totals: | 3780.00 | 3780.00 |

| Account | Debits | Credits |
|-------------------------|------------|------------|
| | | |
| Checking Account | 550.00 | |
| Office Equipment | 225.00 | |
| Computer Hardware | 900.00 | |
| Office Furniture | 945.00 | |
| Accounts Payable | | 680.00 |
| Owners' Equity | | 2600.00 |
| Totals | \$2,620.00 | \$3,280.00 |
| Difference (Net Income) | \$660.00 | |

| Income Statement Accounts | | |
|---------------------------|------------|----------|
| Account | Debits | Credits |
| Sales | | 500.00 |
| Website Hosting | 120.00 | |
| Repairs & Maintenance | 25.00 | |
| Fuel | 25.00 | |
| Rent | 500.00 | |
| Office Supplies | 75.00 | |
| Subscriptions | 65.00 | |
| Meals | 45.00 | |
| Phone Service | 150.00 | |
| Electric Service | 100.00 | |
| Bank Charges | 25.00 | |
| Credit Card Fees & Int | 30.00 | |
| Totals | \$1,160.00 | \$500.00 |
| Difference (Net Income) | | \$660.00 |

Income Statement (Profit and Loss)

| Income Statement Format: |
|--------------------------|
| Revenue |
| - Cost of Goods Sold |
| |
| = Gross Margin |
| - Expenses |
| = Net Income(Loss) |

| Income St December | | |
|--------------------------|----------|------------|
| Sales | | \$500.00 |
| Website Hosting | | \$120.00 |
| Gross Margin | | \$380.00 |
| Operating Expenses | | |
| Repairs & Maintenance | \$25.00 | |
| Fuel | \$25.00 | |
| Rent | \$500.00 | |
| Office Supplies | \$75.00 | |
| Subscriptions | \$65.00 | |
| Meals | \$45.00 | |
| Phone Service | \$150.00 | |
| Electric Service | \$100.00 | |
| Bank Charges | \$25.00 | |
| Credit Card Interest | \$30.00 | |
| Total Operating Expenses | | \$1,040.00 |
| Net Income(Loss) | | \$(660.00) |

Important Income Statement Concepts:

- Date Ranges
- Accounting Types
- Characteristics of Data
- · Gross Margin
- Operating Expenses
- Fixed and Variable Costs
- Net Income
- Break-Even Point

Date Ranges:

The Income Statement covers only limited periods of time. Income Statements show balances from the beginning of the fiscal year up to the cutoff date for the statement. Balances accumulate for the Income Statement Accounts for up to one year and then they are reset to zero by a closing entry and begin again. The cutoff for the year is the fiscal, or business year which is often the same as the calendar year. Since our transactions started in November, this statement covers November and December. At the end of this section on financial statements, I will show the closing entry that resets the income statement account balances to zero.

Accounting Types:

- Revenue(Sales, Income)
- Costs of Goods Sold (Costs, Cost of Sales)
- Expenses (G&A, General and Administrative Costs)
- Other Income and Expenses

Characteristics of Data:

The Income Statement contains cost and expense items that are consumable and usually recurring. You should be able to develop good expectations about your expenses and profitability based on the patterns you will see from month to month.

Gross Margin:

Components of Gross Margin:

- Revenue: The amount charged for the goods and services provided by a business within its industry.
- Costs of Goods Sold: The amount it costs to pay for the goods and services provided by a business.

Gross Margin = Revenue – Cost of Goods Sold. Gross Margin, also called Gross Profit, represents the amount of revenue remaining after direct costs to cover operating expenses.

Gross Margin is meaningful because it shows the *direct* relationship between the sales price and the costs of products. Increases in product costs may trigger you to increase your sales price.

Using a Gross Margin Percentage (Gross Margin/Revenue) is often more useful then a dollar amount when you are benchmarking and/or determining whether your Margin is reasonable.

Operating Expenses:

Operating Expenses are often referred to simply as "Expenses". Examples of expenses are administrative payroll, office rent and other office expenses such as utilities, phones and supplies.

Expenses are different from Costs and it is important to separate them from each other on the Income Statement. Although they each represent the costs of doing business, changes in Costs will occur for different reasons and with different timing than changes in Expenses.

While changes in both costs and expenses affect Net Income, the focus of *Costs* management is primarily Gross Margin while the focus of *Expense* management is primarily Sales Revenue and Net Income.

Fixed and Variable Charges:

Examples of fixed charges are those that are based on a wide date/time range (ie..per month) such as rent and to a large degree, the monthly charges for utilities, internet and basic phone charges. Fixed charges will remain fixed at about the same amount from month to month.

Examples of variable charges are those that are based on a per unit basis or a narrow date/time range (per hour, per day) such as payroll and the cost of the products you manufacture and/or sell.

Fixed and Variable charges will be found in both the Cost(of Goods Sold) and the (Operating) Expense sections of the Income Statement but in general there will be more fixed charges in Expenses and more Variable charges in Costs.

It is important to identify which of the charges on your Income Statement are fixed and which are variable so that you can budget and plan for the level of Sales that will be required to break even and hopefully make a profit.

Net Income:

If we look at Net Income from the perspective of the Income Statement we know that Net Income only represents the profits for the current year after the *consumable* costs and expenses, it does *not* take into account the costs of items with *lasting* value. It is important to remember that Net Income equals profit, it does not equal cash. Net Income actually represents the change in the book value of the business for the current year.

Break-Even:

The Break Even Point or Amount is the level of Sales you must reach in order to cover your costs and expenses. To Break-Even, our Gross Margin, which is Sales – Cost of Goods Sold, must be equal to Operating Expenses.

**Caution: The Term Break-Even refers to Items on the Income Statement only, it is not related to cash. You could break even and still be short of cash due to changes in Balance Sheet Accounts.

Let's take a look at our Income Statement and determine what level of sales will be required to break-even assuming that our Operating Expenses will remain at about the same amount of \$1040 for each future month up to a sales level of \$5000. Operating Expenses will always increase at some point, associating them with sales levels is a good reminder to adjust expectations. I just picked \$5000 out the air, when you do this be sure to carefully watch the actual levels where your expenses increase.

Break-Even:

The Break-Even formula is Total Fixed Charges divided by (Sales Price per Unit – Variable Cost per Unit)

Scenario 1: Operating Expenses are fixed at \$1040 and Website Hosting is a fixed monthly charge of \$120 which does not change regardless of our sales volume.

- Break Even Point = (\$1040 + \$120)/\$500 = 2.32
- Break Even Amount = 2.32 units of advertising * \$500 price per unit = \$1160

Scenario 2: Operating Expenses are fixed at \$1040 and Website Hosting is a variable, per unit charge. We can assume our costs will be \$120 per every \$500 in Sales.

- Break Event Point = \$1040 / (\$500 \$120) = \$1040 / \$380 = 2.737
- Break Even Amount = 2.727 units of advertising * \$500 Sales Price = \$1368.50

Scenario 3: Operating Expenses are fixed at \$1040 per month and Website Hosting is a combined fixed, per month charge of \$100 plus a variable, per unit charge. We will assume our per unit costs will be \$20 per every \$500 in Sales. In this scenario we will calculate the required Gross Margin by using %'s.

- Break Even Point = (\$1040 + \$100)/(\$500 \$20) = \$1140/\$480 = 2.375
- Break Even Amount = 2.375 units of advertising * \$500 Sales Price = \$1187.50

You may not have exact numbers to use for the break even analysis. Use your best estimates. In the previous examples I estimated that the operating expenses would remain fixed, in reality they are going to fluctuate a bit. Also, I don't know how many advertising units make up \$500 so I substituted the per month revenue for the per unit price. I still get useful information from these calculations because now I have a target, and I know that to break even, I have to sell more than twice as much as I did in December and I have to carefully watch my Operating Expenses.

Balance Sheet

| The Format for the Balance Sheet is: Current Assets |
|---|
| + Fixed Assets |
| Total Assets |
| Current Liabilities |
| + Long Term Liabilities |
| Total Liabilities |
| Owners' Equity |
| + Net Income (Loss) |
| Total Equity |
| Total Liabilities and Equity |
| Total Assets must equal Total Liabilities plus Equity |

| Balance | Sheet |
|---------|---------|
| Decembe | er 2010 |

Assets

Current Assets

Fixed Assets
Office Equipment \$225.00
Computer Hardware \$900.00
Office Furniture \$945.00

\$550.00

Total Fixed Assets \$2,070.00

Total Assets \$2,620.00

Liabilities and Equity

Checking Account

Current Liabilities
Accounts Payable

Total Liabilities
\$680.00

Equity

Owners' Equity \$2,600.00
Net Income (Loss) \$(660.00)

Total Equity \$1,940.00

Total Liabilities and Equity \$2,620.00

Important Balance Sheet Concepts:

- Date Ranges
- Accounting Types
- Characteristics of Data
- Assets
- Liabilities
- Equity
- Retained Earnings
- Net Income

Date Ranges:

Unlike Income Statement Accounts, Balance Sheet Accounts are not reset to zero at the end of each fiscal year. The Balance Sheet covers the entire life of the Business up to the cutoff date on the Statement.

Accounting Types:

- Assets
- Liabilities
- Equity

Characteristics of Data:

The Balance Sheet contains items with lasting value, they remain on the Balance Sheet until they are disposed of. **The purpose of Balance Sheet Items is to either make or save money for the business.

Assets:

Assets are things owned by the business. Assets are split into classifications of Current Assets, Fixed Assets and Other Assets. (On the balance sheet, Assets = Liabilities + Equity)

Current Assets are cash and short term assets that are expected to be converted into cash at approximately their stated value within one fiscal year. Current Assets are expected to pay for current liabilities.

Fixed Assets are items that the business has invested in in order to make or sell their products and services. These asset are depreciable meaning they will lose their value and/or usefulness over time and a portion of their cost will be transferred to the Income Statement each year.

Other Assets are intangible items such as patents and trademarks.

Liabilities:

Liabilities are items owed by the business to another party. Liabilities are split into two classifications, Current Liabilities and Long Term Liabilities. (On the balance sheet, Liabilities = Assets - Equity)

Current Liabilities are the counterpart to current assets. They are expected to be paid for within one year at approximately their current book value and Current assets are expected to pay for current liabilities.

The life span of Long Term Liabilities is great then one year. Examples of Long Term Liabilities are loans and notes.

Equity:

Equity, which can be computed as Assets – Liabilities, represents the net book value of a company.

The Equity section of the Balance Sheet has two parts. The first part is the *Owners or Stockholders Equity* section, this section tells you how much has been *invested* into the business by its owners. The second part is the *Retained Earnings* section, this section tells you how much of the business's value is due to *income*. It is customary for companies that are not C Corporations to merge the two sections together.

Retained Earnings is the amount of Income from prior years that has been kept by the business and not distributed to its owners.

Net Income:

Net Income for the current year is not an Account or an Accounting Type but it is reported on the balance sheet below Owners' Equity and Retained Earnings as part of the Equity section. Net Income is a calculated amount on the Balance Sheet just like it is on the Income Statement.

Net Income can also be calculated using a rewrite of the Accounting Equation:

- Accounting Equation: Assets = Liabilities + Equity
- Equity = Owners Equity + Retained Earnings + Net Income
- Assets Liabilities Owners Equity Retained Earnings = Net Income

The Net Income calculated on the Balance Sheet should be equal to the Net Income calculated on the Income Statement. If it is not, make sure that debits = credits on the Trial Balance and make sure you're not missing any accounts on either the Balance Sheet or the Income Statement.

Important Balance Sheet Ratios

The Balance Sheet provides the information to calculate financial ratios which are used evaluate the effectiveness of a business and its management.

Financial ratios are a direct indication of the ability of items on the balance sheet to make money for the

business. Classifications of financial ratios are Liquidity, Asset Management, Debt (Liability) Management and Profitability, which show the combined effect of the previous three classifications.

Liquidity Ratios:

- Current Ratio = Current Assets/Current Liabilities
 - A Current Ratio of at least 1:1 (or >= 1) indicate that there is at least one dollar of current assets for each dollar of current debt.
- Quick Ratio = Current Assets Inventory/Current Liabilities
 - A Quick Ratio of at least 1:1 indicates that there is at least one dollar of cash or cash equivalent (including accounts receivable) for each dollar of current debt.

The difference between the Ratios above is the absence of Inventory in the Quick Ratio. When inventory is sold there can be an additional delay in receiving payment for the sale because it might be tied up in Accounts Receivable for an additional 30 days after the sale. By excluding Inventory from the Quick Ratio, you can match up the timing of cash flow for the Current Assets and the Current Liabilities.

Since we do not have any inventory, both our Current and Quick Ratios are the same. We already know that our ratios will be less than 1 because our current liabilities are higher than our current assets.

Current Ratio =
$$$550/$680 = .81$$

This means trouble because we are unable to pay our payable obligation with the cash we have on hand. We need more sales, more investment from our owner or we need to sell fixed assets.

Other Ratios: I am not going to give examples or analysis of the other ratios but I am listing their formulas below. Their titles are pretty self explanatory as to what they measure.

Asset Management:

- **Inventory Turnover:** Sales/Inventory
- Days Sales Outstanding (Receivable Turnover): Receivables/Annual Sales/360
- **Fixed Asset Turnover:** Sales/Net Fixed Assets (Net Fixed Assets = Fixed Assets Accumulated Depreciation)
- Total Asset Turnover: Sales/Total Assets

Debt (Liability) Management:

• **Total debt to total assets:** Total debt/Total assets

Profitability:

• Gross Margin: Gross Margin/Sales

• **Profit Margin:** Net Income/Sales

• Basic Earning Power: Net Income/Total Assets

• Return on Assets: Net Income/Total Assets

• **Return on Equity:** Net Income/Equity

Results for these ratios can be measured against industry averages for your industry and your area. It is also important to watch your ratios over time to measure progress.

Congratulations! You have completed this workbook. I have tried to cover the topics in such a way as to make them both simple and useful. I hope I have succeeded. Keep in mind that this workbook covers topics in a general way, it is important to continue with in depth studies of accounting and finance topics over time.

Thank you for purchasing this workbook, the proceeds of this workbook are helping me to develop my accounting software. I have designed new accounting software (using the double entry format) and I am currently working on developing it because it has been my experience that the current software does not provide enough information to its users. The result of that lack of information makes errors and embezzlement easy to do and hard to catch. I believe my system will go miles towards preventing those problems so thank you again.

As an added bonus - In pages that follow, there are examples of:

- Alternative formats for the Income Statement and the Balance Sheet that each provide a column for the current month's activity rather than just a cumulative balance.
- The Year End Closing Journal Entry
- Financial Statements after Closing Entry
- The General Ledger for the Accounts in this workbook (prior to closing entry)
- Depreciation
- Cash Flow Statement
- Accounts Payable and Accounts Receivable Sub-Ledgers
- Bank Reconciliation Examples

Alternative Income Statement and Balance Sheet Formats

| Income | Statement | |
|---------------------------------|---------------|------------|
| Decemb | per 31, 2010 | |
| | Current Month | Balance |
| Sales | \$500.00 | \$500.00 |
| Cost of Goods Sold | \$120.00 | \$120.00 |
| Gross Margin | \$380.00 | \$380.00 |
| Operating Expenses | | |
| Repairs & Maintenance | \$25.00 | \$25.00 |
| Fuel | \$25.00 | \$25.00 |
| Rent | | \$500.00 |
| Office Supplies | | \$75.00 |
| Subscriptions | \$65.00 | \$65.00 |
| Meals | \$45.00 | \$45.00 |
| Phone Service | \$150.00 | \$150.00 |
| Electric Service | \$100.00 | \$100.00 |
| Bank Charges | \$15.00 | \$25.00 |
| Credit Card Interest | \$30.00 | \$30.00 |
| Total Operating Expenses | \$455.00 | \$1,040.00 |
| Net Income(Loss) | \$(75.00) | \$(660.00) |

| D - ! | - Ob4 | | | | | | | |
|---|---|--|--|--|--|--|--|--|
| | Balance Sheet | | | | | | | |
| Decembe | December 31, 2010 | | | | | | | |
| | | | | | | | | |
| Acceta | Current Month | Balance | | | | | | |
| Assets Current Assets | | | | | | | | |
| | \$360.00 | \$550.00 | | | | | | |
| Checking Account | φ300.00 | Ф 550.00 | | | | | | |
| Fixed Assets | | | | | | | | |
| Office Equipment | \$0.00 | \$225.00 | | | | | | |
| Computer Hardwar | • | \$900.00 | | | | | | |
| Office Furniture | \$945.00 | \$945.00 | | | | | | |
| Since Farmare | | ——— | | | | | | |
| Total Fixed Assets | \$1,345.00 | \$2,070.00 | | | | | | |
| | • , | . , | | | | | | |
| | | | | | | | | |
| Total Assets | \$1,705.00 | \$2,620.00 | | | | | | |
| | \$1,705.00 | \$2,620.00 | | | | | | |
| Liabilities and Equity | \$1,705.00 | \$2,620.00 | | | | | | |
| Liabilities and Equity Current Liabilities | | , | | | | | | |
| Liabilities and Equity | | \$2,620.00 \$680.00 | | | | | | |
| Liabilities and Equity Current Liabilities | | , | | | | | | |
| Liabilities and Equity Current Liabilities Accounts Payable | \$680.00 | \$680.00 | | | | | | |
| Liabilities and Equity Current Liabilities Accounts Payable | \$680.00 | \$680.00 | | | | | | |
| Liabilities and Equity Current Liabilities Accounts Payable Total Liabilities | \$680.00 | \$680.00 | | | | | | |
| Liabilities and Equity Current Liabilities | \$680.00 \$680.00 \$1,100.00 | \$680.00 | | | | | | |
| Liabilities and Equity Current Liabilities | \$680.00 \$680.00 \$1,100.00 \$(75.00) | \$680.00 \$680.00 \$2,600.00 \$(660.00) | | | | | | |
| Liabilities and Equity Current Liabilities | \$680.00 \$680.00 \$1,100.00 | \$680.00 \$680.00 \$2,600.00 | | | | | | |
| Liabilities and Equity Current Liabilities | \$680.00 \$680.00 \$1,100.00 \$(75.00) \$1,025.00 | \$680.00 \$680.00 \$2,600.00 \$(660.00) | | | | | | |

Year End Closing Journal Entry (reset Income Statement Accounts to zero to start a new year)

The closing entry zeros out income statement account balances by taking the balance of each income statement account at year end and making an opposite entry for it. For example, "Sales" had a *credit* balance of \$500 at year end so to clear it out, we make a \$500 *debit* entry. Notice that all the accounts in this journal entry are Income Statement Accounts with the exception of Retained Earnings. Total debits and credits of each journal entry must be equal, so the difference between the income statement account balances (Net Income/(Loss)) is posted to Retained Earnings. Retained Earnings, as you might recall is the Balance Sheet account that accumulates the total Net Income(Loss), that has not been distributed to owners, for all prior years.

| Date | Account | Description | Ref | Debit | Credit |
|----------|---------|-------------------------|-----|------------|------------|
| Dec/2010 | 3020 | Retained Earnings | 17 | \$660.00 | |
| | 4000 | Sales | | \$500.00 | |
| | 5000 | Website Hosting | | | \$120.00 |
| | 7000 | Repairs & Maintenance | | | \$25.00 |
| | 7020 | Fuel | | | \$25.00 |
| | 7100 | Rent | | | \$500.00 |
| | 7120 | Office Supplies | | | \$75.00 |
| | 7140 | Subscriptions | | | \$65.00 |
| | 7160 | Meals | | | \$45.00 |
| | 7200 | Phone Service | | | \$150.00 |
| | 7220 | Electric Service | | | \$100.00 |
| | 7300 | Bank Charges | | | \$25.00 |
| | 7320 | Credit Card Interest | | | \$30.00 |
| | | *Year End Closing Entry | | | |
| | | Totals | | \$1,160.00 | \$1,160.00 |

Financial Statements after Closing Entries:

| Income Stateme | nt |
|---------------------------------|---------|
| January 1, 2011 | |
| | Balance |
| Sales | \$0.00 |
| Cost of Goods Sold | \$0.00 |
| Gross Margin | \$0.00 |
| Operating Expenses | |
| Repairs & Maintenance | \$0.00 |
| Fuel | \$0.00 |
| Rent | \$0.00 |
| Office Supplies | \$0.00 |
| Subscriptions | \$0.00 |
| Meals | \$0.00 |
| Phone Service | \$0.00 |
| Electric Service | \$0.00 |
| Bank Charges | \$0.00 |
| Credit Card Interest | \$0.00 |
| Total Operating Expenses | \$0.00 |
| Net Income(Loss) | \$0.00 |

| | Trial Balance | | | | | |
|-------|------------------------|--------|---------|--|--|--|
| | January 1, 2011 | | | | | |
| Accou | ınnt | Debits | Credits | | | |
| 1000 | Checking Account | 550.00 | | | | |
| 1500 | Office Equipment | 225.00 | | | | |
| 1520 | Computer Hardware | 900.00 | | | | |
| 1540 | Office Furniture | 945.00 | | | | |
| 2000 | Accounts Payable | | 680.00 | | | |
| 3000 | Owners' Equity | | 2600.00 | | | |
| 3020 | Retained Earnings | | -660.00 | | | |
| 4000 | Sales | | 0.00 | | | |
| 5000 | Website Hosting | 0.00 | | | | |
| 7000 | Repairs & Maintenance | 0.00 | | | | |
| 7020 | Fuel | 0.00 | | | | |
| 7100 | Rent | 0.00 | | | | |
| 7120 | Office Supplies | 0.00 | | | | |
| 7140 | Subscriptions | 0.00 | | | | |
| 7160 | Meals | 0.00 | | | | |
| 7200 | Phone Service | 0.00 | | | | |
| 7220 | Electric Service | 0.00 | | | | |
| 7300 | Bank Charges | 0.00 | | | | |
| 7320 | Credit Card Fees & Int | 0.00 | | | | |

| | Balance Sheet January 1, 2011 | |
|--|--|--|
| _ | | Balance |
| Assets | | |
| Current | Assets | # FF0.00 |
| | Checking Account | \$550.00 |
| Fixed A | ssets | |
| | Office Equipment | \$225.00 |
| | Computer Hardware | \$900.00 |
| | Office Furniture | \$945.00 |
| Total Fi | xed Assets | \$2,070.00 |
| | | |
| Total A | Assets | \$2,620.00 |
| Liabilit | Assets ties and Equity Liabilities | \$2,620.00 |
| Liabilit | ties and Equity | \$2,620.00 \$680.00 |
| Liabili t Current | ties and Equity Liabilities | , |
| Liabilit Current Total Li | ties and Equity Liabilities Accounts Payable | \$680.00 |
| Liabili t Current | ties and Equity Liabilities Accounts Payable abilities | \$680.00 |
| Liabilit Current Total Li | ties and Equity Liabilities Accounts Payable abilities Owners' Equity | \$680.00 \$680.00 \$2,600.00 |
| Liabilit Current Total Li | ties and Equity Liabilities Accounts Payable abilities | \$680.00 \$680.00 \$2,600.00 \$(660.00) |
| Liabilit Current Total Li | ties and Equity Liabilities Accounts Payable abilities Owners' Equity Retained Earnings Net Income (Loss) | \$680.00 |

General Ledger Accounts (Prior to Closing Entry)

| Account: 1000 | Checking Account | | | | | |
|---------------|--------------------------------|-----|------------|----------|---------------|-----------------|
| Date | Description | Ref | Debit | Credit | Period Totals | Account Balance |
| Nov/2010 | Owner Investment | 1 | \$1,500.00 | | \$1,500.00 | \$1,500.00 |
| Nov/2010 | Rent, Check#100 | 2 | | \$500.00 | \$1,000.00 | \$1,000.00 |
| Nov/2010 | Office Phone/Fax, Check #101 | 3 | | \$75.00 | \$925.00 | \$925.00 |
| Nov/2010 | Printer, Check 102 | 4 | | \$150.00 | \$775.00 | \$775.00 |
| Nov/2010 | Office Supplies, 103 | 5 | | \$75.00 | \$700.00 | \$700.00 |
| Nov/2010 | Server Parts, 104 | 6 | | \$500.00 | \$200.00 | \$200.00 |
| Nov/2010 | Bank Charges | 7 | | \$10.00 | \$190.00 | \$190.00 |
| | Ending Balance – Nov/2010 | | | | \$190.00 | \$190.00 |
| Dec/2010 | Owner Investment | 8 | \$1,100.00 | | \$1,100.00 | \$1,290.00 |
| Dec/2010 | Office Chair, Check 105 | 9 | | \$700.00 | \$400.00 | \$590.00 |
| Dec/2010 | Oil Change, Check 106 | 10 | | \$25.00 | \$375.00 | \$565.00 |
| Dec/2010 | Advertising Sales | 11 | \$500.00 | | \$875.00 | \$1,065.00 |
| Dec/2010 | Credit Card Payment, Check 107 | 15 | | \$500.00 | \$375.00 | \$565.00 |
| Dec/2010 | Bank Charges | 16 | | \$15.00 | \$360.00 | \$550.00 |
| | Ending Balance – Dec/2010 | | | | \$360.00 | \$550.00 |

| | General Ledger | | | | | | |
|---------------|---------------------------|-----|----------|--------|---------------|-----------------|--|
| Account: 1500 | Office Equipment | | | | | | |
| Date | Description | Ref | Debit | Credit | Period Totals | Account Balance | |
| Nov/2010 | Phone/Fax, Check # 101 | 3 | \$75.00 | | \$75.00 | \$75.00 | |
| Nov/2010 | Printer, Check 102 | 4 | \$150.00 | | \$225.00 | \$225.00 | |
| | Ending Balance – Nov/2010 | | | | \$225.00 | \$225.00 | |
| | Ending Balance – Dec/2010 | | | | \$225.00 | \$225.00 | |

| General Ledger | | | | | | |
|----------------|---------------------------|-----|----------|--------|---------------|-----------------|
| Account: 1520 | Computer Hardware | | | | | |
| Date | Description | Ref | Debit | Credit | Period Totals | Account Balance |
| Nov/2010 | Server Parts, Check 104 | 6 | \$500.00 | | \$500.00 | \$500.00 |
| | | | | | | |
| | Ending Balance – Nov/2010 | | | | \$500.00 | \$500.00 |
| | | | | | | |
| Dec/2010 | Server Parts, Credit Card | 14 | \$400.00 | | \$400.00 | \$900.00 |
| | | | | | | |
| | Ending Balance – Dec/2010 | | | | \$400.00 | \$900.00 |

| Account: 1540 | Office Furniture | | | | | |
|---------------|---------------------------|-----|----------|--------|---------------|-----------------|
| Date | Description | Ref | Debit | Credit | Period Totals | Account Balance |
| Dec/2010 | Office Chair, Check 105 | 9 | \$700.00 | | \$700.00 | \$700.00 |
| Dec/2010 | Desk, Credit Card | 14 | \$245.00 | | \$945.00 | \$945.00 |
| | | | | | | |
| | Ending Balance – Dec/2010 | | | | \$945.00 | \$945.00 |

| | General Ledger | | | | | | |
|---------------|----------------------------|-----|----------|----------|---------------|-----------------|--|
| Account: 2000 | Accounts Payable | | | | | | |
| Date | Description | Ref | Debit | Credit | Period Totals | Account Balance | |
| Dec/2010 | Phone Expense | 12 | | \$150.00 | -\$150.00 | -\$150.00 | |
| Dec/2010 | Electric Expense | 13 | | \$100.00 | -\$250.00 | -\$250.00 | |
| Dec/2010 | Credit Card | 14 | | \$930.00 | -\$1,180.00 | -\$1,180.00 | |
| Dec/2010 | Credit Card Pmt, Check 107 | 15 | \$500.00 | | -\$680.00 | -\$680.00 | |
| | | | | | | | |
| | Ending Balance – Dec/2010 | | | | -\$680.00 | -\$680.00 | |

| General Ledger | | | | | | |
|----------------|---------------------------|-----|-------|------------|---------------|-----------------|
| Account: 3000 | Owners Equity | | | | | |
| Date | Description | Ref | Debit | Credit | Period Totals | Account Balance |
| Nov/2010 | Owner Investment | 1 | | \$1,500.00 | -\$1,500.00 | -\$1,500.00 |
| | Ending Balance – Nov/2010 | | | | -\$1,500.00 | -\$1,500.00 |
| Dec/2010 | Owner Investment | 8 | | \$1,100.00 | -\$1,100.00 | -\$2,600.00 |
| | Ending Balance – Dec/2010 | | | | -\$1,100.00 | -\$2,600.00 |

| General Ledger | | | | | | | |
|----------------|------------------------------|-----|----------|--------|---------------|-----------------|--|
| Account: 4000 | Advertising Sales | | | | | | |
| Date | Description | Ref | Debit | Credit | Period Totals | Account Balance | |
| Dec/2010 | Advertising Sales on Website | 11 | \$500.00 | | \$500.00 | \$500.00 | |
| | | | | | | | |
| | Ending Balance – Dec/2010 | | | | \$500.00 | \$500.00 | |

| | General Ledger | | | | | | | | |
|---------------|-------------------------------|-----|----------|--------|---------------|-----------------|--|--|--|
| Account: 5000 | Account: 5000 Website Hosting | | | | | | | | |
| Date | Description | Ref | Debit | Credit | Period Totals | Account Balance | | | |
| Dec/2010 | Hosting Expense, Credit Card | 14 | \$120.00 | | \$120.00 | \$120.00 | | | |
| | | | | | | | | | |
| | Ending Balance – Dec/2010 | | | | \$120.00 | \$120.00 | | | |

| General Ledger | | | | | | |
|----------------|---------------------------|-----|---------|--------|---------------|-----------------|
| Account: 7000 | Repairs and Maintenance | | | | | |
| Date | Description | Ref | Debit | Credit | Period Totals | Account Balance |
| Dec/2010 | Oil Change, Check 106 | 10 | \$25.00 | | \$25.00 | \$25.00 |
| | | | | | | |
| | Ending Balance – Dec/2010 | | | | \$25.00 | \$25.00 |

| General Ledger | | | | | | | |
|----------------|---------------------------|-----|---------|--------|---------------|-----------------|--|
| Account: 7020 | <u>Fuel</u> | | | | | | |
| Date | Description | Ref | Debit | Credit | Period Totals | Account Balance | |
| Dec/2010 | Fuel, Credit Card | 14 | \$25.00 | | \$25.00 | \$25.00 | |
| | | | | | | | |
| | Ending Balance – Dec/2010 | | | | \$25.00 | \$25.00 | |

| | General Ledger | | | | | | | | |
|---------------|----------------------------------|-----|----------|--------|---------------|-----------------|--|--|--|
| Account: 7100 | <u>Rent</u> | | | | | | | | |
| Date | Description | Ref | Debit | Credit | Period Totals | Account Balance | | | |
| Nov/2010 | Rent, Check #100 | 2 | \$500.00 | | \$500.00 | \$500.00 | | | |
| | | | | | | | | | |
| | Ending Balance – Nov/2010 | | | | \$500.00 | \$500.00 | | | |
| | | | | | | | | | |
| | Ending Balance – Dec/2010 | | | | \$500.00 | \$500.00 | | | |

| | General Ledger | | | | | | | |
|---------------|---------------------------|-----|---------|--------|---------------|-----------------|--|--|
| Account: 7120 | Office Supplies | | | | | | | |
| Date | Description | Ref | Debit | Credit | Period Totals | Account Balance | | |
| Nov/2010 | Check #103 | 5 | \$25.00 | | \$25.00 | \$25.00 | | |
| | Ending Balance – Nov/2010 | | | | \$25.00 | \$25.00 | | |
| | Ending Balance – Dec/2010 | | | | \$25.00 | \$25.00 | | |

| General Ledger | | | | | | | | |
|----------------|-----------------------------------|-----|---------|--------|---------------|-----------------|--|--|
| Account: 7140 | Account: 7140 Subscriptions | | | | | | | |
| Date | Description | Ref | Debit | Credit | Period Totals | Account Balance | | |
| Dec/2010 | Magazine Subscription, Credit Crd | 14 | \$65.00 | | \$65.00 | \$65.00 | | |
| | | | | | | | | |
| | Ending Balance – Dec/2010 | | | | \$65.00 | \$65.00 | | |

| General Ledger | | | | | | | |
|----------------|---------------------------|-----|---------|--------|---------------|-----------------|--|
| Account: 7160 | <u>Meals</u> | | | | | | |
| Date | Description | Ref | Debit | Credit | Period Totals | Account Balance | |
| Dec/2010 | Business Lunch | 14 | \$45.00 | | \$45.00 | \$45.00 | |
| | | | | | | | |
| | Ending Balance – Dec/2010 | | | | \$45.00 | \$45.00 | |

| | General Ledger | | | | | | | |
|---------------|------------------------------|-----|----------|--------|----------|-----------------|--|--|
| Account: 7200 | Phone Expense | | | | | | | |
| Date | Description | Ref | Debit | Credit | Balance | Account Balance | | |
| Dec/2010 | Phone Expense, Accts Payable | 12 | \$150.00 | | \$150.00 | \$150.00 | | |
| | | | | | | | | |
| | Ending Balance – Dec/2010 | | | | \$150.00 | \$150.00 | | |

| | General Ledger | | | | | | | | |
|---------------|---------------------------------|-----|----------|--------|---------------|-----------------|--|--|--|
| Account: 7220 | Electric Expense | | | | | | | | |
| Date | Description | Ref | Debit | Credit | Period Totals | Account Balance | | | |
| Dec/2010 | Electric Expense, Accts Payable | 13 | \$100.00 | | \$100.00 | \$100.00 | | | |
| | | | | | | | | | |
| | Ending Balance – Dec/2010 | | | | \$100.00 | \$100.00 | | | |

| | General Ledger | | | | | | | |
|---------------|----------------------------|-----|---------|--------|---------------|-----------------|--|--|
| Account: 7300 | Bank Charges | | | | | | | |
| Date | Description | Ref | Debit | Credit | Period Totals | Account Balance | | |
| Nov/2010 | From Bank Statement | 7 | \$10.00 | | \$10.00 | \$10.00 | | |
| | Ending Balance – Nov/2010 | | | | \$10.00 | \$10.00 | | |
| | Littling Datablee 11072010 | | | | Ψ10.00 | Ψ10.00 | | |
| Dec/2010 | From Bank Statement | 16 | \$15.00 | | \$15.00 | \$25.00 | | |
| | Ending Balance – Dec/2010 | | | | \$15.00 | \$25.00 | | |

| | General Ledger | | | | | | | |
|---------------|-------------------------------|-----|---------|--------|---------------|-----------------|--|--|
| Account: 7320 | Credit Card Fees and Interest | | | | | | | |
| Date | Description | Ref | Debit | Credit | Period Totals | Account Balance | | |
| Dec/2010 | From Credit Card Statement | 14 | \$30.00 | | \$30.00 | \$30.00 | | |
| | | | | | | | | |
| | Ending Balance – Dec/2010 | | | | \$30.00 | \$30.00 | | |

Depreciation

Reclassifications:

The class of Assets that are Depreciated is Fixed Assets. Fixed Assets are things the business owns and uses in its operations. Examples of fixed assets are equipment, buildings and furnishings. I have already told you that the criteria for classifying a purchase as a fixed asset is the expected length of value but now we'll add another condition. If the purchased item is expected to last more than one year AND its cost is "material" then it is classified as an Asset otherwise it is classified as an Expense.

The amount that is considered to be "Material" is a bit subjective and I suggest that you discuss this with your tax accountant in advance but then always apply the same criteria for each situation. I will use the amount of \$500 but again, this affects your taxes and I cannot give you tax advice.

Using the criteria of \$500 as the threshold for the fixed asset classification, there are some items on our balance sheet that must be reclassified before we can begin the depreciation process. Notice that I am not reclassifying the \$400 charge for Server Parts. All costs involved to put an asset into working order are considered to be part of that asset's cost so the server parts cost of \$500 plus its additional parts cost of \$400 are combined for a \$900 value for the server.

Journal Entry

| Date | Account | Description | Ref | Debit | Credit |
|----------|---------|---|-----|----------|----------|
| Nov/2010 | 7180 | Office Expense (New Account) | | \$225.00 | |
| | 1500 | Office Equipment (Phone/Fax) | | | \$75.00 |
| | 1500 | Office Equipment (Printer) | | | \$150.00 |
| | | | | | |
| Dec/2010 | 7180 | Office Expense | | \$245.00 | |
| | 1540 | Office Furniture (Desk) | | | \$245.00 |
| | | *to reclass equipment from asset to expense | | | |

Financial Statements After Reclassifying Assets to Expense:

| Trial Balance Accounts | | | | | | |
|------------------------|------------------------|---------|---------|--|--|--|
| Accou | nnt | Debits | Credits | | | |
| 1000 | Checking Account | 550.00 | | | | |
| 1500 | Office Equipment | 0.00 | | | | |
| 1520 | Computer Hardware | 900.00 | | | | |
| 1540 | Office Furniture | 700.00 | | | | |
| 2000 | Accounts Payable | | 680.00 | | | |
| 3000 | Owners' Equity | | 2600.00 | | | |
| 4000 | Sales | | 500.00 | | | |
| 5000 | Website Hosting | 120.00 | | | | |
| 7000 | Repairs & Maintenance | 25.00 | | | | |
| 7020 | Fuel | 25.00 | | | | |
| 7100 | Rent | 500.00 | | | | |
| 7120 | Office Supplies | 75.00 | | | | |
| 7130 | Office Expense | 470.00 | | | | |
| 7140 | Subscriptions | 65.00 | | | | |
| 7160 | Meals | 45.00 | | | | |
| 7200 | Phone Service | 150.00 | | | | |
| 7220 | Electric Service | 100.00 | | | | |
| 7300 | Bank Charges | 25.00 | | | | |
| 7320 | Credit Card Fees & Int | 30.00 | | | | |
| | Totals: | 3780.00 | 3780.00 | | | |

| Balance Sheet Accounts | | | | | |
|-------------------------|------------|------------|--|--|--|
| Account | Debits | Credits | | | |
| Checking Account | 550.00 | | | | |
| Office Equipment | 0.00 | | | | |
| Computer Hardware | 900.00 | | | | |
| Office Furniture | 700.00 | | | | |
| Accounts Payable | | 680.00 | | | |
| Owners' Equity | | 2600.00 | | | |
| Totals | \$2,150.00 | \$3,280.00 | | | |
| Difference (Net Income) | \$1,130.00 | | | | |

| Income Statement Accounts | | | | | |
|---------------------------|------------|------------|--|--|--|
| Account | Debits | Credits | | | |
| Sales | | 500.00 | | | |
| Website Hosting | 120.00 | | | | |
| Repairs & Maintenance | 25.00 | | | | |
| Fuel | 25.00 | | | | |
| Rent | 500.00 | | | | |
| Office Supplies | 75.00 | | | | |
| Office Expense | 470.00 | | | | |
| Subscriptions | 65.00 | | | | |
| Meals | 45.00 | | | | |
| Phone Service | 150.00 | | | | |
| Electric Service | 100.00 | | | | |
| Bank Charges | 25.00 | | | | |
| Credit Card Fees & Int | 30.00 | | | | |
| Totals | \$1,630.00 | \$500.00 | | | |
| Difference (Net Income) | | \$1,130.00 | | | |

As you can see on the financial statement accounts on the previous page, the reclassification journal entry decreases fixed assets but it also increases expenses which has the effect of increasing the Net Loss for the year by \$470, we go from a loss of \$660 to a loss of \$1130. This entry did not change the amount of money that was spent, only the way the expenditures are classified.

Taxes are paid on Net Income which is Revenue – Costs and Expenses. Expenses decrease net income but purchasing assets does not so you pay taxes on cash that has been used to invest in the business's assets. Assets are considered to be part of the value of the business rather than an expense to the business.

Book Values:

Each item on the Balance Sheet is stated at its original value or cost. Since the accounts accumulate their balances from "the beginning of time", each balance sheet item also stays there at its original value until it is sold, written off or satisfied (debts paid off or equity repurchased).

Items that are listed on the Balance Sheet do lose their value over time so instead of reducing their original account values, contra accounts are used to write down, depreciate or amortize them. Contra Accounts are the same Accounting Type as their counterparts but if their counterpart is a debit account, the contra account is a credit account. The Net Value of the Original Account and the Contra Account together reflects the decrease in book value without losing the historical value. Contra Accounts like Accumulated Depreciation prevent items from "falling off" the Balance Sheet while they are still owned by the entity because when the item's value eventually depreciates to zero, it is still part of the original account balance.

Depreciation Calculations:

Depreciation is determined by type of fixed asset. The United States' depreciation methods, classes of assets and depreciation examples are listed in IRS Publication 946 at http://www.irs.gov/pub/irs-pdf/p946.pdf. This publication is freely available and provides a wide range of information. If you are in a country other than the US, check your country's tax department websites for similar information.

It is common for a business to use different depreciation methods for their accounting and their tax purposes. Always ask a tax professional for guidance in making decisions that have tax implications.

There are different depreciation methods to choose from but for book purposes, the usual method of depreciation is called Straight-Line Depreciation. Straight Line Depreciation divides the cost of the asset by its life span. So, for our Office Chair which cost \$700, it would be \$700/7 = \$100 depreciation per year.

Depreciation Worksheet:

Make a new list each year of your Assets and update the Accumulated Depreciation

| Depreciation Worksheet 2010 | | | | | | | | | |
|-----------------------------|------------------|------------------|---------------------------|----------------------|--------------|---------------------|--------------------------|------------------------|--|
| Fixed Asset | Purchase Date | Original Cost | Less: Salvage Value | Depreciable Value | Life Span | Cost / Life Span | Accumulated Depreciation | Annual Depreciation | Monthly Depreciation (Annual / 12) |
| Office Chair | Dec/2010 | \$700.00 | \$0.00 | \$700.00 | 7 | \$700/7 | \$0.00 | \$100.00 | \$8.33 |
| Server | Dec/2010 | \$900.00 | \$0.00 | \$900.00 | 5 | \$900/5 | \$0.00 | \$180.00 | \$15.00 |
| Total Depreciation | | | | | | | | \$280.00 | \$23.33 |

Depreciation Journal Entries for November and December 2010:

| Date | Account | Description | Debit | Credit |
|----------|---------|--|---------|---------|
| Nov/2010 | 7010 | Depreciation Expense (New Account) | \$23.33 | |
| | 1590 | Accumulated Depreciation (New Account) | | \$23.33 |
| | | | | |
| Dec/2010 | 7010 | Depreciation Expense | \$23.34 | |
| | 1590 | Accumulated Depreciation | | \$23.34 |
| | | *depreciation entries (December entry rounded up due to uneven division) | | |

Financial Statements After Depreciation Entries:

| Trial Balance Accounts | | | | | | | |
|------------------------|--------------------------|---------|---------|--|--|--|--|
| Acco | unnt | Debits | Credits | | | | |
| 1000 | Checking Account | 550.00 | | | | | |
| 1500 | Office Equipment | 0.00 | | | | | |
| 1520 | Computer Hardware | 900.00 | | | | | |
| 1540 | Office Furniture | 700.00 | | | | | |
| 1590 | Accumulated Depreciation | | 46.67 | | | | |
| 2000 | Accounts Payable | | 680.00 | | | | |
| 3000 | Owners' Equity | | 2600.00 | | | | |
| 4000 | Sales | | 500.00 | | | | |
| 5000 | Website Hosting | 120.00 | | | | | |
| 7000 | Repairs & Maintenance | 25.00 | | | | | |
| 7010 | Depreciation Expense | 46.67 | | | | | |
| 7020 | Fuel | 25.00 | | | | | |
| 7100 | Rent | 500.00 | | | | | |
| 7120 | Office Supplies | 75.00 | | | | | |
| 7130 | Office Expense | 470.00 | | | | | |
| 7140 | Subscriptions | 65.00 | | | | | |
| 7160 | Meals | 45.00 | | | | | |
| 7200 | Phone Service | 150.00 | | | | | |
| 7220 | Electric Service | 100.00 | | | | | |
| 7300 | Bank Charges | 25.00 | | | | | |
| 7320 | Credit Card Fees & Int | 30.00 | | | | | |
| | Totals: | 3826.67 | 3826.67 | | | | |

| Balance Sheet Accounts | | | | | |
|--------------------------|------------|------------|--|--|--|
| Account | Debits | Credits | | | |
| Checking Account | 550.00 | | | | |
| Computer Hardware | 900.00 | | | | |
| Office Furniture | 700.00 | | | | |
| Accumulated Depreciation | | 46.67 | | | |
| Accounts Payable | | 680.00 | | | |
| Owners' Equity | | 2600.00 | | | |
| Totals | \$2,150.00 | \$3,326.67 | | | |
| Difference (Net Income) | \$1,176.67 | | | | |

| Income Statement Accounts | | | | | |
|---------------------------|------------|------------|--|--|--|
| Account | Debits | Credits | | | |
| Sales | | 500.00 | | | |
| Website Hosting | 120.00 | | | | |
| Repairs & Maintenance | 25.00 | | | | |
| Depreciation Expense | 46.67 | | | | |
| Fuel | 25.00 | | | | |
| Rent | 500.00 | | | | |
| Office Supplies | 75.00 | | | | |
| Office Expense | 470.00 | | | | |
| Subscriptions | 65.00 | | | | |
| Meals | 45.00 | | | | |
| Phone Service | 150.00 | | | | |
| Electric Service | 100.00 | | | | |
| Bank Charges | 25.00 | | | | |
| Credit Card Fees & Int | 30.00 | | | | |
| Totals | \$1,676.67 | \$500.00 | | | |
| Difference (Net Income) | | \$1,176.67 | | | |

New Beginning Worksheet for 2011 – add lines for new assets as they are purchased

| Depreciation Worksheet 2011 | | | | | | | | | |
|-----------------------------|------------------|------------------|---------------------------|----------------------|--------------|---------------------|--------------------------|------------------------|--|
| Fixed Asset | Purchase Date | Original Cost | Less: Salvage Value | Depreciable Value | Life Span | Cost / Life Span | Accumulated Depreciation | Annual Depreciation | Monthly Depreciation (Annual / 12) |
| Office Chair | Dec/2010 | \$700.00 | \$0.00 | \$700.00 | 7 | \$700/7 | \$16.67 | \$100.00 | \$8.33 |
| Server | Dec/2010 | \$900.00 | \$0.00 | \$900.00 | 5 | \$900/5 | \$30.00 | \$180.00 | \$15.00 |
| Total Depreciation | | | | | | | | \$280.00 | \$23.33 |

Cash Flow Statement

The Cash Flow Statement reconciles the difference between Net Income and Cash for the year. It also gives more detailed information about how the Net Book Value of the Business has changed due to increases and/or decreases in Assets, Liabilities and Equity.

Cash Flow Statement Format:

• Operating Activities

- Net Income
- + Depreciation Expense (+ Increase and -Decrease in Accumulated Depreciation)
- + Increases in Current Liabilities
- + Decreases in Current Assets
- - Increases in Current Assets
- - Decreases in Current Liabilities

• Investing Activities

- + Decreases in Long Term/Fixed Assets (Independent of Accumulated Depreciation)
- - Increases in Long Term/Fixed Assets (Independent of Accumulated Depreciation)

• Financing Activities

- + Increases in Long Term Liabilities/Debt
- - Decreases in Long Term Liabilities/Debt
- + Increases in Owners' Capital
- - Decreases in Owners' Capital
- - Increases in Dividends
- Cash (Beginning Cash Balance +/- Net Increase/Decrease = Ending Cash Balance)

| Statement of Casl | n Flows | | |
|---|------------|--------------|-------------|
| | November | December | Tota |
| Cash Flows From Operating Activities | | | |
| Net Income | (\$833.33) | (\$343.34) | (\$1,176.67 |
| Depreciation | \$23.33 | \$23.34 | \$46.67 |
| Increase in Payables | \$0.00 | \$680.00 | \$680.00 |
| Net Cash Provided by Operating Activities | (\$810.00) | \$360.00 | (\$450.00 |
| Cash Flows From Investing Activities | | | |
| Increase in Fixed Assets | \$500.00 | \$1,100.00 | \$1,600.00 |
| Net Cash USED by Investing Activities | (\$500.00) | (\$1,100.00) | (\$1,600.00 |
| Cash Flows From Financing Activities | | | |
| Increased in Owners' Equity | \$1,500.00 | \$1,100.00 | \$2,600.00 |
| Net Cash Provided by Financing Activities | \$1,500.00 | \$1,100.00 | \$2,600.0 |
| Increase in Cash (Net Cash Flow) | \$190.00 | \$360.00 | \$550.0 |
| Cash at Beginning of Year | \$0.00 | \$0.00 | \$0.00 |

| Balance Sheet | |
|--------------------------|-------------|
| December 2010 | |
| Assets | |
| Current Assets | |
| Checking Account | \$550.00 |
| Fixed Assets | |
| Computer Hardware | \$900.00 |
| Office Furniture | \$700.00 |
| Accumulated Depreciation | \$(46.67) |
| Total Fixed Assets | \$1,553.33 |
| Total Assets | \$2,103.33 |
| Liabilities and Equity | |
| Current Liabilities | |
| Accounts Payable | \$680.00 |
| Total Liabilities | \$680.00 |
| Equity | |
| Owners' Equity | \$2,600.00 |
| Net Income (Loss) | \$(1176.67) |
| Total Equity | \$1,423.33 |
| | |

Cash Flow Statement/Statement of Cash Flows:

The Statements on the previous page include the changes made to the books for Depreciation.

The Cash Flow Statement is sometimes neglected but it is a very important Financial Statement. Unlike the Balance Sheet which accumulates its values from the beginning of a business, this statement is a yearly statement. Increases and decreases in each of the categories indicate increases and/or decreases for the current year only. I like to format it with a column for each month but it could be shown simply with one column with totals for the year.

If you compare the Cash Flow Statement and the Balance Sheet, you can see that Cash Flow Statement is like a yearly Balance Sheet that has been rearranged. All amounts for the Cash Flow Statement can be found on the Balance sheet and calculated by subtracting the prior account balances from the current account balances.

It is useful to think of items on the Cash Flow Statement as either uses or sources of funds. If they are uses, they will decrease the final cash balance and if they are sources, they will increase the final cash balance.

Operating: This section starts with Net Income, which is a *Source* of Funds, and then it increases Net Income to include non-cash expenses such as depreciation and/or amortization. The other accounts included in this section are Current Assets and Current Liabilities. Increases in Current Assets (Uses of Funds) are subtracted and increases in Current Liabilities (Sources of Funds) are added.

Investing: This section includes Fixed and Other Assets (non current). Assets are Uses of Funds so increases to this section are subtracted from Net Income in the calculation. Investing in this case refers to the business investing in itself by increasing its own assets as well as investing in other businesses and funds.

Financing: This section includes Long Term Liability accounts and Equity Accounts which are both Sources of Funds. Increases in Long Term Liability and Equity accounts are added to Net Income.

The total of the three sections, Net Cash Flow, is added to the beginning cash balance to calculate the ending cash balance. Compare this figure to make sure it balances with your ending Cash Account Balance.

Subledger Overview

Throughout this workbook we've covered the three organizing elements used by the General Accounting System:

• Chart of Accounts: Listing of All Accounts

• **Journals:** the line by line detail of each Transaction.

• Ledgers: Account Balances

These three elements work great for financial accounting and for producing financial reports but they do not provide enough detail for the day to day management of a business.

If you recall in my description of the Chart of Accounts, I said that each account should describe the *types* of things you will keep track of and not *specific* things. Being limited to tracking only "types" of things causes problems because it just doesn't provide enough information to effectively manage a business. Instead of complicating our General Accounting System to keep track of the extra detail we use subsystems. Sub-Systems include more elements than just a ledger but from here on out, I will refer to them as Subledgers or subledger systems. In accounting software the subsystems are referred to as Modules.

Subledger systems keep track of details by using the same elements we use in the General System only with more detail. Each subledger system includes an Account list, a Journal and a Ledger. We can have more than one subledger system but each one is separate from the others.

Accounts Payable and Accounts Receivable are the most common of the subledger systems and they are very similar to each other. They were developed to keep track of who we owe money to and who owes us money. Each has an account list, a journal and a (sub)ledger. For Accounts Payable, the account list is a list of creditor accounts and for Accounts Receivable it is a list of customer accounts.

Accounts Payable Subledger System:

Each subledger represents at least one account from the General Ledger and the balance of the subledger at any given time must be equal to the GL (General Ledger) Account(s) it represents.

For example, the total balance of all Accounts in our Accounts Payable Subledger is equal to the balance for GL Account 2000 (Accounts Payable) - which is the GL Account the subledger represents.

The listing below shows the summary for the Accounts Payable Subledger.

| Accounts Payable Subledger Register | | | | | |
|-------------------------------------|----------|--|--|--|--|
| December | 2010 | | | | |
| Account | Balance | | | | |
| Phone Company | 150.00 | | | | |
| Electric Company | 100.00 | | | | |
| Credit Card Company | 430.00 | | | | |
| Total | \$680.00 | | | | |

Compare the Accounts Payable Subledger Total against the Total for the Accounts Payable Account on the Trial Balance Below:

| Accounts Payable Subledger Register | | | | | |
|-------------------------------------|----------|--|--|--|--|
| December | r 2010 | | | | |
| Account | Balance | | | | |
| | | | | | |
| Phone Company | 150.00 | | | | |
| Electric Company | 100.00 | | | | |
| Credit Card Company | 430.00 | | | | |
| Total | \$680.00 | | | | |

| General Ledger – Trial Balance | | | | | | |
|--------------------------------|------------|------------|--|--|--|--|
| Decem | ber 2010 | | | | | |
| Account | Debits | Credits | | | | |
| Chapting Appoint | 550.00 | | | | | |
| Checking Account | 550.00 | | | | | |
| Office Equipment | 225.00 | | | | | |
| Computer Hardware | 900.00 | | | | | |
| Office Furniture | 945.00 | | | | | |
| Accounts Payable | | 680.00 | | | | |
| Owners' Equity | | 2600.00 | | | | |
| Sales | | 500.00 | | | | |
| Website Hosting | 120.00 | | | | | |
| Rent | 500.00 | | | | | |
| Repairs & Maintenance | 25.00 | | | | | |
| Fuel | 25.00 | | | | | |
| Subscriptions | 65.00 | | | | | |
| Meals | 45.00 | | | | | |
| Phone Service | 150.00 | | | | | |
| Electric Service | 100.00 | | | | | |
| Office Supplies | 75.00 | | | | | |
| Bank Charges | 25.00 | | | | | |
| Credit Card Fees & Int | 30.00 | | | | | |
| Totals | \$3,780.00 | \$3,780.00 | | | | |

Just like for the General Ledger, the Accounts for the Subledgers each have their own page(s).

Accounts Payable Subledgers:

| | Accounts Payable Subledger | | | | | | |
|----------|----------------------------|-----|-----------|----------|----------|----------|--|
| Account: | Phone Company | | | | | | |
| Date | Description | Ref | Invoice # | Amount | Payments | Balance | |
| Dec/2010 | December Phone Bill | 12 | 123-1210 | \$150.00 | \$0.00 | \$150.00 | |
| | | | | | | | |
| | Ending Balance – Dec/2010 | | | \$150.00 | \$0.00 | \$150.00 | |

| | Accounts Payable Subledger | | | | | |
|----------|----------------------------------|-----|------------|----------|----------|----------|
| Account: | Electric Company | | | | | |
| Date | Description | Ref | Invoice # | Amount | Payments | Balance |
| Dec/2010 | December Electric Bill | 13 | 8987y-1210 | \$100.00 | \$0.00 | \$100.00 |
| | | | | | | |
| | Ending Balance – Dec/2010 | | · | \$100.00 | \$0.00 | \$100.00 |

| | Accounts Payable Subledger | | | | | | |
|----------|--------------------------------|-----|-----------|----------|----------|----------|--|
| Account: | Credit Card Company | | | | | | |
| Date | Description | Ref | Invoice # | Amount | Payments | Balance | |
| Dec/2010 | December Credit Card Bill | 14 | 1439-1210 | \$930.00 | \$0.00 | \$930.00 | |
| Dec/2010 | Credit Card Payment(check 107) | 15 | 1439-1210 | \$0.00 | \$500.00 | \$430.00 | |
| | | | | | | | |
| | Ending Balance – Dec/2010 | | | \$930.00 | \$500.00 | \$430.00 | |

Subsidiary Journals:

When you are using a system that has subledgers, the initial journal entries that involve your subledgers are entered into the subledger journals. For example, whenever you receive an invoice you enter it into the Accounts Payable Journal first and then it is entered into the Ledger and then into the General System through the General Journal and General Ledger.

The Path of entries involving subsystems:

Subsidiary Journal -> Post to Subsidiary Ledger by its Account -> Post to General Journal -> Post to General Ledger by General Ledger Account.

Subsidiary Journal Format:

The format for Transactions in the Accounts Payable (and other) Subledger Journals is similar to the format for the General Journal that we practiced earlier except they require at least two more columns in the grid. One for the Subledger Account, and one for an Invoice Number (or other identifying reference number). Another column for the due date might also be added.

| | Accounts Payable Journal | | | | | | | | | |
|---------------------|--------------------------|----------|------|------------------|-------------------|----------------------------------|-----------|--|--|--|
| Subledger Account | Invoice # | Date | Ref | Debit Account | Credit Account | Description | Amount | | | |
| Phone Company | 123_1210 | 12/01/10 | ap12 | 7200 | 2000 | December Phone Bill | \$150.00 | | | |
| Electric Company | 8987y-1210 | 12/10/10 | ap13 | 7220 | 2000 | December Electric Bill | \$100.00 | | | |
| Credit Card Company | 1439-1210 | 12/15/10 | ap14 | 7320 | 2000 | December Credit Card Fees | \$30.00 | | | |
| | | | | 1540 | 2000 | Desk | \$245.00 | | | |
| | | | | 7020 | 2000 | Fuel | \$25.00 | | | |
| | | | | 7140 | 2000 | Magazine Subs | \$65.00 | | | |
| | | | | 7160 | 2000 | Business Lunch | \$45.00 | | | |
| | | | | 5000 | 2000 | Website Hosting | \$120.00 | | | |
| | | | | 1500 | 2000 | Server Parts | \$400.00 | | | |
| Credit Card Company | 1439-1210 | 12/31/10 | ap15 | 2000 | 1000 | Credit Card Payment (check 1070) | -\$500.00 | | | |

^{**} Important: Individual transactions for each Subledger Account must have a unique identifying number, in this case, it's an Invoice Number. That number combined with the Subledger Account creates a unique pair that prevents duplicate payments and provide a way for each party to reference the transaction for payments or if disputes or questions arise.

General Journal:

Since the system requires that all financial transactions have an entry in the General Ledger, they must also have an entry in the General Journal. This requires some duplication of effort but it is necessary. So, once the entries are posted to the Subledger Journals, they are then summarized and posted to the General Journal after which the Balances in the General Ledger are updated.

Journal Entries into the General Journal:

| Date | Account | Description | Ref | Debit | Credit |
|----------|---------|-------------------------------------|------|----------|----------|
| Dec/2010 | 7200 | Phone Service | ap12 | \$150.00 | |
| | 2000 | Accounts Payable (Phone Company) | | | \$150.00 |
| Dec/2010 | 7220 | Electric Service | ap13 | \$100.00 | |
| | 2000 | Accounts Payable (Electric Company) | | | \$100.00 |
| Dec/2010 | 7320 | Credit Card Interest and Fees | ap14 | \$30.00 | |
| | 1540 | Office Desk | | \$245.00 | |
| | 7020 | Fuel | | \$25.00 | |
| | 7140 | Magazine Subscription | | \$65.00 | |
| | 7160 | Business Lunch | | \$45.00 | |
| | 5000 | Website Hosting | | \$120.00 | |
| | 1500 | Server Parts | | \$400.00 | |
| | 2000 | Accounts Payable (Credit Card) | | | \$930.00 |
| Dec/2010 | 2000 | Accounts Payable (Credit Card) | ap15 | \$500.00 | |
| | 1000 | Checking Account (Check 107) | | | \$500.00 |

Sales and the Accounts Receivable Subledger System:

I did not give any Accounts Receivable examples in the workbook so I'll create one here. Accounts Receivable is directly related to sales so in order to make it a meaningful example lets create some scenarios.

Scenario 1:

Sold advertising on the site for \$500 but instead of receiving cash immediately, I sent an bill to my customer and received payment later in the month. In order to record this invoice I need to create an account in the Chart of Accounts for Accounts Receivable which is a current asset. I will give it account number 1200.

Accounts Receivable Journal Entries:

| Accounts Rec Journal | | | | | | | | |
|--|--------|-------------|--------|------|------|--------------------------------------|----------|--|
| Subledger Account Invoice # Date Ref Debit Account Description | | Description | Amount | | | | | |
| Big Customer | 1_1210 | 12/01/10 | Ar17 | 1200 | 4000 | Invoice for Advertising sold on Site | \$500.00 | |
| Big Customer | 1_1210 | 12/10/10 | Ar18 | 1000 | 1200 | Deposited Check into bank account | \$500.00 | |

Accounts Receivable Subledger for "Big Customer":

| | Accounts Receivable Subledger | | | | | | |
|----------|-------------------------------|-----|-----------|----------|----------|----------|--|
| Account: | Big Customer | | | | | | |
| Date | Description | Ref | Invoice # | Amount | Payments | Balance | |
| Dec/2010 | Advertising Sale | 17 | 1_1210 | \$500.00 | \$0.00 | \$500.00 | |
| Dec/2010 | Received Payament | 18 | 1_1210 | \$0.00 | \$500.00 | \$0.00 | |
| | | | | | | | |
| | Ending Balance – Dec/2010 | | | \$500.00 | \$500.00 | \$0.00 | |

Journal Entry into General Journal:

| Date | Account | Description | Ref | Debit | Credit |
|----------|---------|---------------------|------|----------|----------|
| Dec/2010 | 1200 | Accounts Receivable | ar17 | \$500.00 | |
| | 4000 | Sales | | | \$500.00 |
| | | | | | |
| Dec/2010 | 1000 | Bank Account | ar18 | \$500.00 | |
| | 1200 | Accounts Receivable | | | \$500.00 |

Let's compare both of our subledger balances against our General Ledger after the entries. Usually we don't show an account that has a zero balance on the financial statements but I am showing the Accounts Receivable Account this time to illustrate the comparison.

| Accounts Receivable Subledger Register | | | | | |
|--|---------|--|--|--|--|
| December 2010 | | | | | |
| Account | Balance | | | | |
| | | | | | |
| Big Customer | 0.00 | | | | |
| | | | | | |
| Total | \$0.00 | | | | |

| Accounts Payable Subledger Register | | | | |
|-------------------------------------|----------|--|--|--|
| December 2010 | | | | |
| Account | Balance | | | |
| | | | | |
| Phone Company | 150.00 | | | |
| Electric Company | 100.00 | | | |
| Credit Card Company | 430.00 | | | |
| Total | \$680.00 | | | |

| General Ledger – Trial Balance | | | | |
|--------------------------------|------------|------------|--|--|
| Decembe | er 2010 | | | |
| Account | Debits | Credits | | |
| Checking Account | 550.00 | | | |
| Accounts Receivable | 0.00 | | | |
| Computer Hardware | 900.00 | | | |
| Office Furniture | 700.00 | | | |
| Accumulated Depreciation | | 46.67 | | |
| Accounts Payable | | 680.00 | | |
| Owners' Equity | | 2600.00 | | |
| Sales | | 500.00 | | |
| Website Hosting | 120.00 | | | |
| Repairs & Maintenance | 25.00 | | | |
| Depreciation Expense | 46.67 | | | |
| Fuel | 25.00 | | | |
| Rent | 500.00 | | | |
| Office Supplies | 75.00 | | | |
| Office Expense | 470.00 | | | |
| Subscriptions | 65.00 | | | |
| Meals | 45.00 | | | |
| Phone Service | 150.00 | | | |
| Electric Service | 100.00 | | | |
| Bank Charges | 25.00 | | | |
| Credit Card Fees & Int | 30.00 | | | |
| Totals | \$3,826.67 | \$3,826.67 | | |

The recording of Accounts Receivable and Sales with the sale of products is a bit more complex. Let's create another scenario which involves the sale of inventory. Since the Accounts Receivable entries don't change for entries involving product sales I am not going to go through the subsystem postings for this scenario, I will simply show the General Journal Entries.

Scenario 2:

- Picked up workbooks and invoice for 40 workbooks printed at \$10 each
- Sold 25 workbooks from inventory to Big Customer for \$500. The cost of the workbooks was \$250

First, I need to add an inventory account, a cost of goods sold account for the inventory and then create the entries for this scenario.

Journal Entry into General Journal:

There are two choices that you can make when purchasing products for resale. If you expect to purchase and sell an equal number of your products each month, you can record the purchase directly into your Cost of Goods Sold account. If you expect to purchase in bulk and sell your products gradually, you will need to record the purchase into an Inventory account and transfer the inventory to Cost of Goods Sold as it is sold.

The point here is matching the cost of products and the revenue from sales to each other within the same accounting period (month in this case).

Entry for Workbooks purchased and expected to be sold in same month. (Perpetual Inventory System)

| Date | Account | Description | Ref | Debit | Credit |
|----------|---------|--|-----|----------|----------|
| Dec/2010 | 5050 | Purchases (Cost of Goods Sold) | 19 | \$400.00 | |
| | 1000 | Checking Account | | | \$400.00 |
| | | *record purchase of workbook inventory 40 workbooks at \$10 each | | | |

Entry for Workbooks purchased in bulk and expected to be sold gradually (Periodic Inventory System)

| Date | Account | Description | Ref | Debit | Credit |
|----------|---------|--|-----|----------|----------|
| Dec/2010 | 1100 | Workbook Inventory | 19 | \$400.00 | |
| | 1000 | Checking Account | | | \$400.00 |
| | | *record purchase of workbook inventory 40 workbooks at \$10 each | | | |

To record sale of some of the workbooks (expected # sold to match # purchased for month) (Perpetual)

| Date | Account | Description | Ref | Debit | Credit |
|----------|---------|---|-----|----------|----------|
| Dec/2010 | 1200 | Accounts Receivable | 19 | \$500.00 | |
| | 4000 | Sales | | | \$500.00 |
| | | *record sale of 25 workbooks at \$20 each | | | |

To record sale of some of the workbooks (expected to be sold gradually) (Periodic Inventory System)

| Date | Account | Description | Ref | Debit | Credit |
|----------|---------|---|-----|----------|----------|
| Dec/2010 | 1200 | Accounts Receivable | 19 | \$500.00 | |
| | 4000 | Sales | | | \$500.00 |
| | | *record sale of 25 workbooks at \$20 each | | | |
| Dec/2010 | 5010 | Purchases (Cost of Goods Sold) | 19 | \$250.00 | |
| | 1100 | Workbook Inventory | | | \$250.00 |
| | | *transfer 25 workbooks at \$10 each from inventory to cost of goods | | | |

Year End adjustments for Inventory: Fifteen workbooks remain unsold at year end. If you used the periodic inventory system, no adjustment is required. If you used the perpetual inventory system and recorded your purchases directly into your cost of goods sold account you will need to make an adjustment at year end and reclassify your purchases as inventory.

| Date | Account | Description | Ref | Debit | Credit |
|----------|---------|--|-----|----------|----------|
| Dec/2010 | 1100 | Workbook Inventory | 20 | \$150.00 | |
| | 5050 | Purchases | | | \$150.00 |
| | | *reclass ending inventory of 15 workbooks at \$10 each | | | |

Bank Reconciliations:

Cash Management is another common subsystem, in computerized systems both Cash Disbursements (Cash Out) and Cash Receipts are managed within the same module.

Let's do the bank reconciliations for November and December for our cash transactions (prior to the section on Accounts Receivable and Sales).

Checking Account Register:

| Date | Reconciled | Description | Ref_Check | Addition | Subtraction |
|----------|------------|-------------------------------|-----------|-------------|-------------|
| Nov/2010 | Nov | Deposit | 1 | \$1,500.00 | |
| Nov/2010 | Nov | Check to Landlord for Rent | 2_100 | | \$500.00 |
| Nov/2010 | Nov | Office Shack, Phone/Fax | 3_101 | | \$75.00 |
| Nov/2010 | | Office Shack, Printer | 4_102 | | \$150.00 |
| Nov/2010 | Nov | Office Shack, Office Supplies | 5_103 | | \$75.00 |
| Nov/2010 | | Computer Store, Server Parts | 6_104 | | \$500.00 |
| | | Totals | | \$1,500.00 | \$1,300.00 |
| | | | Diff | -\$1,300.00 | |
| | | Ending Balance | | \$200.00 | |

Compare your own register against the Bank Statement

| November | November Bank Statement | | | | | |
|----------|-------------------------|----------------|------------|-------------|--|--|
| Date | Check | Description | Addition | Subtraction | | |
| Nov/2010 | | Deposit | \$1,500.00 | | | |
| Nov/2010 | 100 | Landlord | | \$500.00 | | |
| Nov/2010 | 101 | Office Shack | | \$75.00 | | |
| Nov/2010 | 103 | Office Shack | | \$75.00 | | |
| Nov/2010 | | Bank Charges | | \$10.00 | | |
| | | Totals | \$1,500.00 | \$660.00 | | |
| | | Diff | -\$660.00 | | | |
| | | Ending Balance | \$840.00 | | | |

Let's say we had not recorded the \$10 bank charge prior to reconciling our bank statement. In this case, the bank has a bank charges of \$10 on the statement that we have not recorded yet into our books so we would make the necessary journal entry.

Journal Entry

| | <i>J</i> | | | | |
|----------|----------|--|-----|---------|---------|
| Date | Account | Description | Ref | Debit | Credit |
| Nov/2010 | 7300 | November Bank Charges | 21 | \$10.00 | |
| | 1000 | Bank Account | | | \$10.00 |
| | | *record Bank Charges from Bank Statement | | | |

Once you have made any additional entries as required, you can check off each item that matches the bank statement.

New Checking Account Register:

| Date | Reconciled | Description | Ref_Check | Addition | Subtraction |
|----------|------------|-------------------------------|-----------|-------------|-------------|
| Nov/2010 | Nov | Deposit | 1 | \$1,500.00 | |
| Nov/2010 | Nov | Check to Landlord for Rent | 2_100 | | \$500.00 |
| Nov/2010 | Nov | Office Shack, Phone/Fax | 3_101 | | \$75.00 |
| Nov/2010 | | Office Shack, Printer | 4_102 | | \$150.00 |
| Nov/2010 | Nov | Office Shack, Office Supplies | 5_103 | | \$75.00 |
| Nov/2010 | | Computer Store, Server Parts | 6_104 | | \$500.00 |
| Nov/2010 | Nov | Bank Charges | | | \$10.00 |
| | | Totals | | \$1,500.00 | \$1,310.00 |
| | | | Diff | -\$1,310.00 | |
| | | Ending Balance | | \$190.00 | |

The items from our register that were not listed on the bank statement are outstanding and we keep them on a list to check against for the next month's statement.

| Outstanding (O/S) Check List | | | | | |
|------------------------------|------------|----------------|------------|----------|--|
| Check | Reconciled | Payee | Check Date | Amount | |
| 102 | December | Office Shack | Nov/2010 | \$150.00 | |
| 104 | | Computer Store | Nov/2010 | \$500.00 | |
| | | Total O/S | | \$650.00 | |

Now we can prepare the Bank Reconciliation:

| Bank Reconciliation November 2010 | |
|---|----------------------------------|
| Balance as per Bank Statement Less Outstanding Checks | \$840.00 \$650.00 \$190.00 |
| Balance as per our books | \$190.00 |

Checking Account Register for December

| Date | Reconciled | Description | Ref_Check | Addition | Subtraction |
|----------|------------|-------------------------|-----------|--------------------|-------------|
| | | Beginning Balance | | \$190.00 | |
| Dec/2010 | December | Checking Account | 8 | \$1,100.00 | |
| Dec/2010 | December | Office Shack, Chair | 9_105 | | \$700.00 |
| Dec/2010 | December | Oil Change | 10_106 | | \$25.00 |
| Dec/2010 | December | Checking Account, Sales | 11 | \$500.00 | |
| Dec/2010 | | Credit Card Payment | 15_107 | | \$500.00 |
| Dec/2010 | December | Bank Charges | 16 | | \$15.00 |
| | | Totals | | \$1,790.00 | \$1,240.00 |
| | | December Totals | | <u>-\$1,240.00</u> | |
| | | Ending Balance | | \$550.00 | |

Compare Checking Account Register and Outstanding Check List against new Bank Statement

| December Bank Statement | | | | |
|-------------------------|-------|-------------------|------------|-------------|
| Date | Check | Description | Addition | Subtraction |
| | | Beginning Balance | \$840.00 | |
| Dec/2010 | | Deposit | \$1,100.00 | |
| Dec/2010 | 102 | Office Shack | | \$150.00 |
| Dec/2010 | 105 | Office Shack | | \$700.00 |
| Dec/2010 | 106 | Car Shop | | \$25.00 |
| Dec/2010 | | Deposit | \$500.00 | |
| Dec/2010 | | Bank Charges | | \$15.00 |
| | | Totals | \$2,440.00 | \$890.00 |
| | | Diff | -\$890.00 | |
| | | Ending Balance | \$1,550.00 | |

| Outstanding (O/S) Check List at December 31, 2010 | | | | |
|---|------------|---------------------|------------|------------|
| Check | Reconciled | Payee | Check Date | Amount |
| 104 | | Office Shack | Nov/2010 | \$500.00 |
| 107 | | Credit Card Company | Dec/2010 | \$500.00 |
| | | | | |
| | | Total O/S | | \$1,000.00 |

| Bank Reconciliation December 2010 | |
|---|--------------------------|
| Balance as per Bank Statement Less Outstanding Checks | \$1,550.00 \$1,000.00 |
| Balance as per General Ledger Account | \$550.00 \$550.00 |

Thank you again for purchasing this workbook, I hope it has been clear and informative and that you have benefited from it.

^{*}Disclaimer: The information in this book is written from my experience, research and training. I do not write with authority from any Accounting Standards organization

^{*}About me: I have been working in Accounting for 22 years, I have a BS degree in Accounting and have done every Accounting job I can think of from Accounts Payable to Controller of a Home Health Care Agency, Home Builder and a Commercial Construction Company. Currently, I provide Accounting and Accounting Software support as a Consultant in Utah.