MODULE 1

BASIC ACCOUNTING CONCEPTS

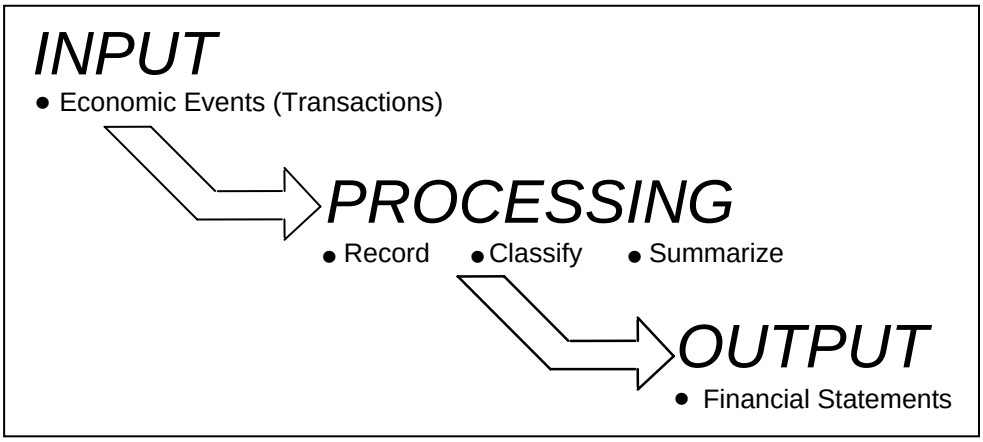
The material in the these two modules should be studied carefully to help you review or relearn basic financial accounting concepts.

THE ACCOUNTING SYSTEM

Accounting can be described as a system designed to provide financial information about economic entities that is intended to be useful in making decisions. The following summary contains examples of major users of financial information and the decisions made by each.

USERS	DECISIONS
• Creditors	• Extending credit for loans or purchases of goods/services.
• Investors	• Investing in stocks, bonds, real estate, etc.
• Labor Unions	• Negotiating labor contracts during collective bargaining.
• Government	• Ensuring compliance with laws, codes, and regulations.
• Management	• Managing the daily activities and operations of the business.

Like all systems, the accounting system consists of the input, processing, and output phases.



THE ACCOUNTING EQUATION

The study of financial accounting begins with the accounting equation. For a corporation, the accounting equation consists of

A = L + SE

ASSETS = LIABILITIES + STOCKHOLDERS' EQUITY

And for a sole proprietorship, the SE becomes OE (owner's equity).

Like any equation, the left side must always equal the right side. Assets must always be equal to liabilities plus stockholders' equity. **Assets** represent the **resources** of the business, and **liabilities** and **stockholders' equity** represent the **sources** of these assets (from where the assets were obtained). Another version of the accounting equation is

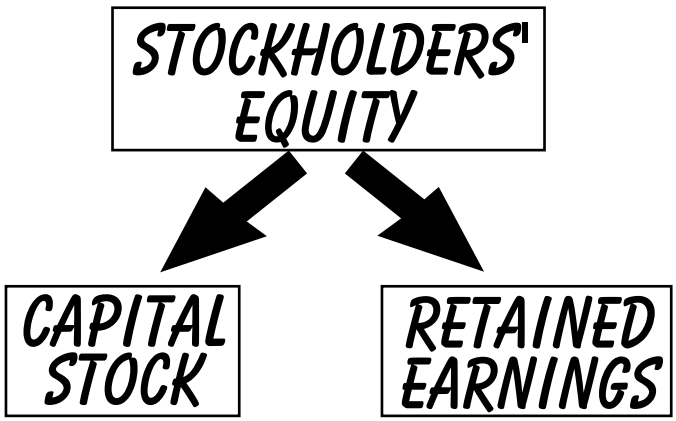
ASSETS = EQUITIES

An equity is a claim on the assets of the business. Liabilities represent claims on the assets by creditors. And stockholders' equity represents claims on the assets by the stockholders (owners of the business).

The terms "asset" and "liability" also have formal definitions. An **asset** can be defined as a probable future economic benefit that is owned or controlled. A more simple definition is "something of value that is owned." The most common examples are cash and accounts receivable (money owed by customers for past goods or services provided to them on credit).

A **liability** can be defined as a probable future sacrifice of economic benefits. It represents an obligation or debt (a promise) to pay cash or provide services in the future. The most common example is accounts payable (money owed to creditors or vendors for past goods or services received from them on credit).

Stockholders' equity has two components – **retained earnings** and **capital stock**.



Capital stock represents the dollar amount of stock sold to investors (stockholders) who become owners as a result of their investment in a corporation. **Retained earnings** represents the total net income (minus any net loss) from all prior years that have been retained (not distributed to the stockholders as dividends). Thus, the **claims** on the assets by stockholders are identified by what is **earned** (retained earnings) and by what is **invested** (capital stock). For a sole proprietorship, both of these components would be combined into one owner's capital account.

Retained earnings consists of **revenues**, **expenses**, and **dividends**. Revenues increase retained earnings, while expenses and dividends decrease retained earnings.

Revenues measure what is **earned**, most often as the result of providing goods or services to customers. An **expense** represents a **cost** that helps to produce a revenue. The terms "earned" and "cost" will be more fully described in Module 2. Total **revenues** minus total **expenses** equals **net income** (or net loss). Never treat a **dividend** as an expense. It is not an expense, because it does not satisfy the

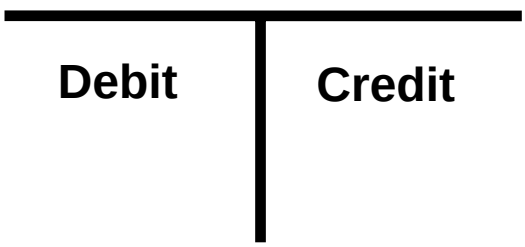
definition of an expense — “a cost that helps to produce a revenue.” Revenues and expenses will be more thoroughly discussed later in this module.

The following examples illustrate the accounting equation and how it remains balanced after recording a transaction (economic event).

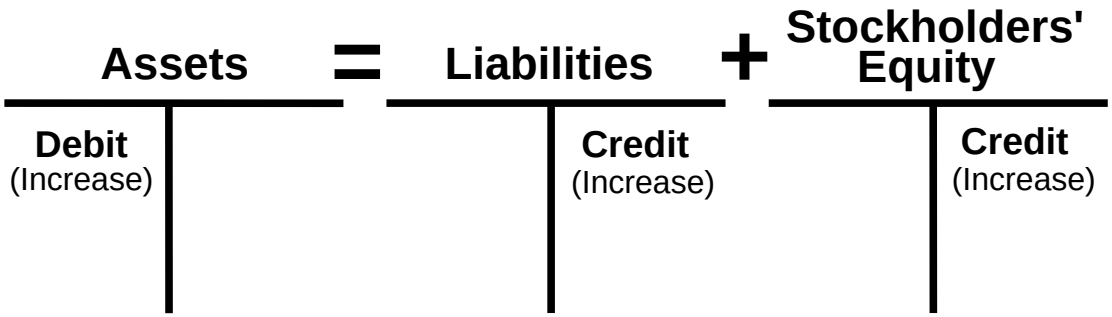
	A	= L	+ SE
(1) PURCHASES A COPY MACHINE FOR $3,000 CASH.	+3,000 –3,000		
(2) PURCHASES A COMPUTER FOR $2,500 ON CREDIT.	+2,500	+2,500	
(3) RECEIVES $500 CASH FOR SERVICES PERFORMED FOR A CUSTOMER.	+500		+500 (REVENUE)
(4) PAYS A UTILITY BILL OF $200 WHEN RECEIVED.	–200		–200 (EXPENSE)
(5) PAYS THE $2,500 OWED TO THE COMPUTER STORE IN (2) ABOVE.	–2,500	–2,500	

USING DEBITS AND CREDITS

Debits and **credits** are used to record transactions. The term debit means “left side” and the term credit means “right side.” One way to illustrate debits and credits is through the use of T-accounts. A T-account is a learning and teaching tool (and often an analytical tool) used to represent an account in the general ledger (described in Module 2). The debit is recorded on the left side of the T-account and the credit is recorded on the right side.

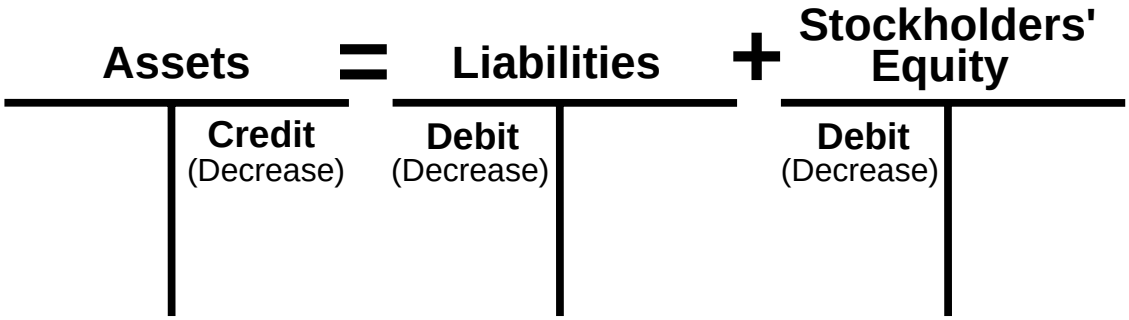


To help you remember how to record debits and credits, the following learning aid might help: A **debit** (defined as left side) is used to increase the left side of the accounting equation (assets) and a **credit** (defined as right side) is used to increase the right side of the accounting equation (liabilities and stockholders' equity).



The debit or credit side that increases the T-account is called the **normal balance**, because this is the balance you would expect to find at the end of the accounting period. For example, you would expect the normal balance for an asset to be a debit.

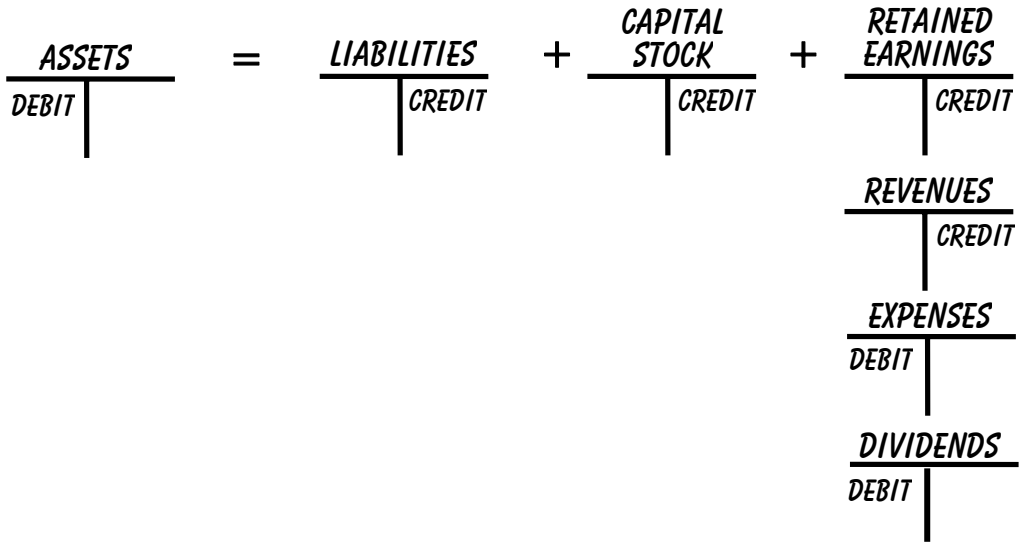
Of course, if a debit increases assets, then a credit has the opposite effect – it decreases assets. Likewise, if a credit increases liabilities and stockholders' equity, then a debit has the opposite effect – it decreases liabilities and stockholders' equity.



As previously explained, stockholders' equity is comprised of capital stock and retained earnings. Therefore, if stockholders' equity has a normal "credit" balance, capital stock and retained earnings will also have a credit balance, because each increases stockholders' equity.

The use of debits and credits with revenues, expenses and dividends is most easily explained by examining retained earnings. If retained earnings has a normal "credit" balance, and if revenues increase retained earnings, then revenues must also have a normal credit balance. Likewise, if expenses and dividends decrease retained earnings, they must have a normal "debit" balance.

Thus, by combining T-accounts and an expanded version of the accounting equation, normal balances can be clearly summarized as follows:



RECORDING JOURNAL ENTRIES

In practice (the real world), transactions are not recorded using T-accounts. Instead, a **journal entry** is recorded. This name is derived from transactions that were entered in a book called the **general journal** prior to the use of computers (described in Module 2). Journal entries use **accounts**, which are specific names given to assets, liabilities, revenues, expenses, and other components that make up stockholders' equity, in order to provide a more detailed record of the transaction. The names "dividends" and "retained earnings" are specific enough to be used as account names. Every business establishes a list of accounts (by name and number). This list is called the **chart of accounts**.

A journal entry retains the same debit (left side) and credit (right side) format as the T-account. All individual debit entries are recorded first, followed by all individual credit entries. Observe in the examples beginning on the next page that after all the debit entries have been recorded, the credit entries are indented to the right of the debit line and recorded, thus retaining the left side/right side format.

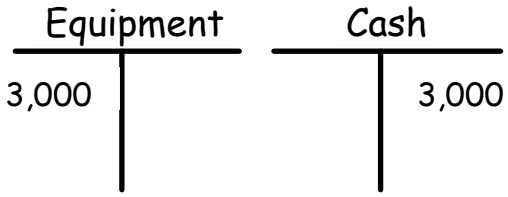
In accounting, transactions are recorded using a **double-entry system**. What this means is that every journal entry requires at least one debit and one credit, and the total debits must equal the total credits. Often, a transaction uses more than one debit and/or credit. This is called a **compound journal entry**. For example, the same transaction might require you to record three debits and two credits or some other combination.

When recording the journal entry for a transaction, a helpful approach for you to use consists of the following steps:

(a) Identify the accounts that are involved (ask what was given up and what was received);
(b) Determine whether the balances in these accounts have increased or decreased;
(c) Record the debits and/or credits required to increase or decrease these accounts.

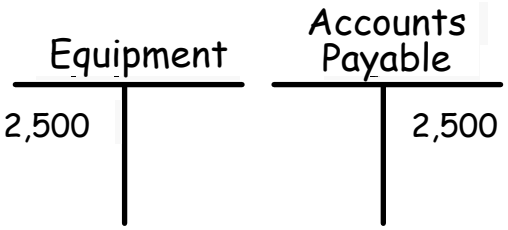
To illustrate how debits and credits are used to record transactions, we will use the transactions that were analyzed earlier in this module. For each transaction, the correct debit and credit will be recorded using both a T-account and a journal entry.

(1) PURCHASES A COPY MACHINE FOR $3,000 CASH.



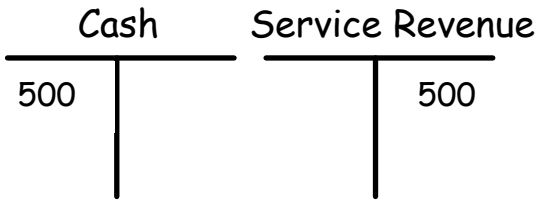
Equipment	3,000	
Cash		3,000

(2) PURCHASES A COMPUTER FOR $2,500 ON CREDIT.



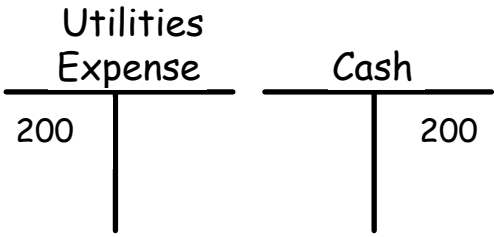
Equipment	2,500	
Accounts Payable		2,500

(3) RECEIVES $500 CASH FOR SERVICES PERFORMED FOR A CUSTOMER.



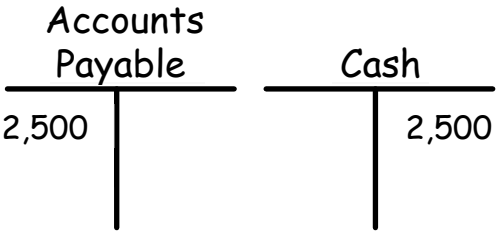
Cash	500	
Service Revenue		500

(4) PAYS A UTILITY BILL OF $200 WHEN RECEIVED.



Utilities Expense	200	
Cash		200

(5) PAYS THE $2,500 OWED TO THE COMPUTER STORE IN (2) ON THE PREVIOUS PAGE.



Accounts Payable	2,500	
Cash		2,500

IMPORTANT: Students often have difficulty at first with the concept of debits and credits, because they have heard these terms used earlier in their lives in their role as consumers. Consider the following examples:

EXAMPLE 1: WHY DOES A BANK TELLER "CREDIT" YOUR ACCOUNT WHEN YOU MAKE A DEPOSIT?

When you make a deposit to your bank checking account, the teller credits your account. Over time, the term "credit" begins to take on a very positive meaning for you. Yet, in this module, you have been told that a credit is used to decrease an asset such as cash. This has a negative meaning. So, which is correct and why does this seeming contradiction exist? To find the answer, you must ask yourself what your account represents on the bank's books. Because the bank is obligated to return your money to you upon demand, your account balance represents a liability for the bank. Therefore, when you make a deposit, this results in an increase to one of the bank's liability accounts. And how does the bank increase a liability? It credits the liability. That's why your account is credited. It is not your checking account that is being credited; it is the liability that your account represents on the bank's books that is being credited and increased. Make sense? The Debit Card used by consumers is a related example. Can you now guess what is being debited when you use the card? That's right — the liability that the balance in your account represents to the bank decreases (debit) each time you use the card, because you are withdrawing cash (most likely to make a purchase) and reducing what the bank owes you.

EXAMPLE 2: WHY DOES A STORE "CREDIT" YOUR ACCOUNT WHEN YOU RETURN MERCHANDISE PURCHASED ON CREDIT?

When you purchase merchandise from a department store on credit and later return it, the department store credits your account. Again, the use of the term "credit" has a positive meaning to you. What's the explanation for this? When you purchase merchandise on credit using your store charge card, you represent an "account receivable" on the books of the department store. This asset is recorded by debiting accounts receivable at the time the purchase is made. The expectation is that the department store will receive payment from you, their customer, sometime in the future. But when you return the merchandise for a refund, the department store "credits" your account — to reduce the account receivable you represent on the store's books.

Now, if you don't understand these two examples, this is a good place to stop and review the earlier material in this module until these examples become clearer before continuing.

MORE ABOUT REVENUES AND EXPENSES

A **revenue** is not an **asset**, but results in the increase or creation of an asset. And an **expense** is not a **liability**, but results in either (a) the increase or creation of a liability or (b) the decrease or use of an asset. Let's look at the following examples to help illustrate these concepts.

EXAMPLE OF A REVENUE:

ALPHA PERFORMS SERVICES FOR $100 AND RECEIVES PAYMENT AT THE TIME THE WORK IS COMPLETED.

A	=	L	+	SE
+100				+100 (revenue)

Observe that the revenue is not an asset, but results in the increase or creation of an asset (cash). If Alpha had not been paid at the time the work was completed, but instead sent an invoice to the customer for future payment, the revenue would still result in the creation of an asset (accounts receivable). Also notice that the revenue increases stockholders' equity (SE), because a revenue increases retained earnings and, as you know, retained earnings increases SE.

EXAMPLE 1 OF AN EXPENSE:

ALPHA RECEIVES A $100 UTILITY BILL AND WILL PAY IT AT A LATER DATE.

A	=	L	+	SE
		+100		-100 (expense)

Observe that the expense is not a liability, but results in the increase or creation of a liability (accounts payable or utilities payable). And the expense decreases SE, because an expense decreases retained earnings.

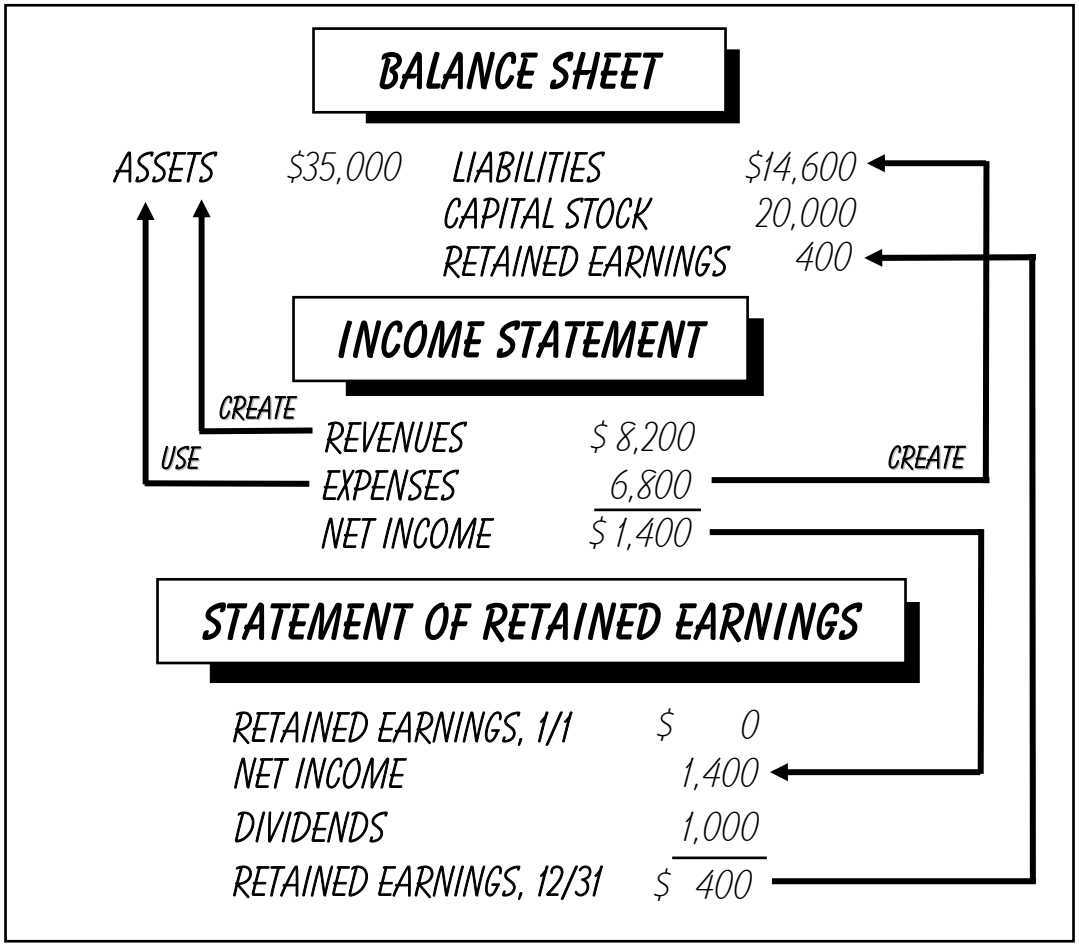
EXAMPLE 2 OF AN EXPENSE:

ALPHA RECEIVES A $100 UTILITY BILL AND PAYS IT AT THE TIME OF RECEIPT.

A	=	L	+	SE
-100				-100 (expense)

Observe that the expense is not a liability, but results in the decrease or use of an asset (cash).

It merits repeating once more that a revenue results in the increase (or creation) of an asset and that an expense results in either the decrease (or use) of an asset or the increase (or creation) of a liability. These concepts are illustrated in the financial statements below. The common denominator that ties these three statements together is **net income** (or net loss). Net income appears on both the income statement and the statement of retained earnings. And net income is eventually added into retained earnings, which is reported on the balance sheet.



The assumption being made in these financial statements is that the business is in its first year of operation and, therefore, the beginning balance for retained earnings is zero. In the second year, the beginning balance for retained earnings will be $400.

These statements are illustrated in an abbreviated format (without specific accounts listed) for simpler explanation of their relationship. If they had contained specific accounts, some of the more common accounts you might have found are:

For *ASSETS* — cash, accounts receivable, inventory, supplies (and other prepaid assets such as insurance, rent, and advertising), equipment, land, and buildings.

For *LIABILITIES* — accounts payable, utilities payable, income tax payable, salaries payable, unearned revenue (described in Module 2), notes payable, and mortgage payable.

For *REVENUES* — sales, professional service fees (also called fees earned, service fees, or service revenue), rent revenue, interest revenue, and gains.

For *EXPENSES* — salaries expense, supplies expense, advertising expense, utilities expense, depreciation expense, rent expense, repairs expense, interest expense, income tax expense, miscellaneous expense, and losses.

CONCLUSION

This completes Module 1. Go back and review this material as many times as is necessary to thoroughly understand the procedures and concepts described. Every word is important for your understanding.

MODULE 2

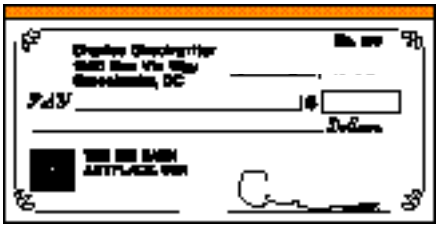
BASIC ACCOUNTING CONCEPTS PART 2

The material in this module completes the coverage of the basic financial accounting procedures and concepts.

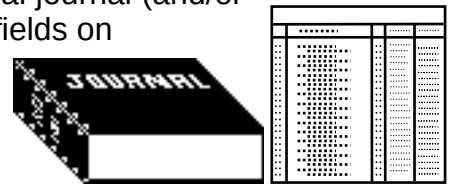
THE ACCOUNTING CYCLE

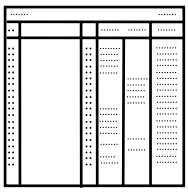
The accounting cycle is a more detailed version of the accounting system that was briefly described in Module 1. Sometimes these terms are used interchangeably. The inputs (economic events/transactions) are processed into the outputs (financial statements). The following seven steps describe the accounting cycle.

STEP ONE is to identify and analyze the transactions (economic events). This requires the existence of objective evidence to establish that a transaction has taken place. Most often, this is accomplished by analyzing source documents. Examples of source documents are invoices (bills to customers and from vendors), bank checks, purchase orders, receipts, bank statements, receiving reports, sales orders, payroll time cards, cash register tapes, contracts, deposit slips, and memoranda.



STEP TWO is to record the transaction in the general journal (and/or special journals). This journal contains pages (or data fields on a computer) of journal entries that have been made to record transactions.





STEP THREE is to post (transfer) the entries from the general journal (or special journal) to each account in the general ledger. The general ledger contains one or more pages (or data fields) for each account listed in the chart of accounts.

STEP FOUR is to prepare an unadjusted trial balance, which lists the ending balance for each account contained in the general ledger. The purpose of the trial balance is to verify that the total debits equal the total credits. It should be noted that even though they equal, this does not guarantee that the ending balance of each account is correct.

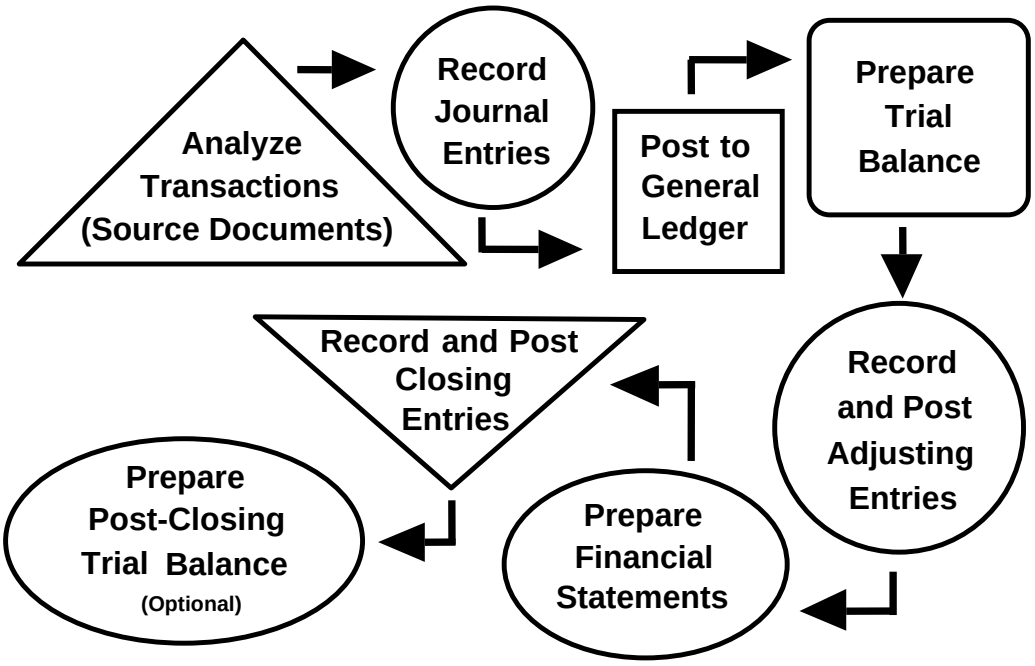
102	CASH	800	
110	ACCOUNTS RECEIVABLE	6,000	
120	SUPPLIES	750	
130	EQUIPMENT	9,410	
210	ACCOUNTS PAYABLE		2,275
315	CAPITAL STOCK		9,800
321	RETAINED EARNINGS		2,985
410	FEES EARNED		6,900
510	UTILITIES EXPENSE	550	
515	SALARIES EXPENSE	1,800	
521	RENT EXPENSE	2,650	
	Debits = Credits	21,960	21,960

STEP FIVE is to record adjusting journal entries in the general journal and post them to the general ledger. Adjusting journal entries are described later in this module.

STEP SIX is to prepare the financial statements from the adjusted trial balance.

STEP SEVEN is to close the books, which is described later in this module.

The following flowchart summarizes the accounting cycle.



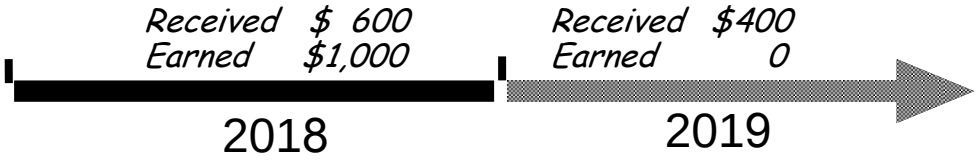
A computerized accounting information system makes use of the same input of raw data from source documents as does a manual accounting system. But in a computerized system, most of the procedures are performed automatically and with total accuracy. Hours of manual processing can be accomplished virtually in seconds. Current output is available on a continuous basis and up-to-date financial statements can be prepared as often as needed without concern for time or cost. These benefits also extend to the very important function of analyzing and interpreting the financial statements. In a computerized accounting information system, steps 3, 4, 6 (including preparation of the adjusted trial balance), and 7 of the accounting cycle (previous page) are automatically performed by the computer.

ACCRUAL ACCOUNTING

Generally accepted accounting principles (GAAP) require use of the accrual basis accounting. The best way to describe the accrual concept is to compare it to cash basis accounting. In cash basis accounting, revenue is recorded only when cash is **received**, and expenses are recorded only when cash is **paid**. With accrual basis accounting, revenue is recognized when **earned** (most often when goods or services are provided) and expenses are recognized when **incurred** (matched to the revenues they help produce). It doesn't matter when cash is paid or received.

Using the timeline below, goods or services provided to customers in 2018 must be recorded as a revenue in 2018 even if the cash is not received from the customers until 2019.

Example: Alpha performed $1,000 of services for Beta in December 2018. Alpha received $600 cash from Beta in December 2018 and $400 from Beta in January 2019.



Revenue should be recognized as follows:

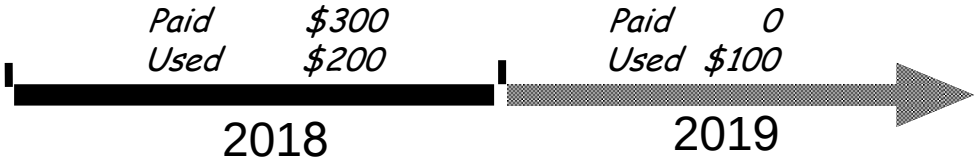
Cash basis accounting — record revenue of $600 in 2018 and $400 in 2019.

Accrual basis accounting — record revenue of $1,000 in 2018, the year in which it is earned, and nothing in 2019.

	2018	2019
Cash	$ 600	$400
Accrual	$1,000	None

With accrual-basis accounting, expenses are matched to revenues they help produce. It doesn't matter when cash is paid.

Example: Alpha paid $300 for supplies in 2018. Alpha used $200 of the supplies in 2017 and the remaining $100 in 2019.



Expenses should be recognized as follows:

Cash basis accounting — expense $300 in 2018.

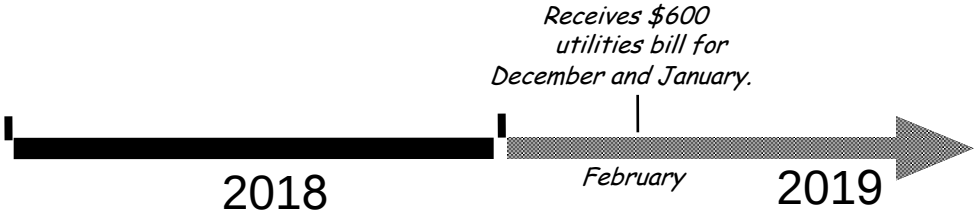
Accrual accounting — expense $200 in 2018 and $100 in 2019.

	2018	2019
Cash	$300	None
Accrual	$200	$100

ADJUSTING JOURNAL ENTRIES

As previously described, to properly measure net income (revenues minus expenses) using accrual accounting, it is necessary to record all revenues in the period earned and all expenses in the period incurred (matched to revenues they help produce), regardless of when cash is paid or received. Thus, the matching of revenues and expenses in the same accounting period is the very **foundation** of accrual accounting. When the same transaction affects the net income of more than one accounting period, adjusting journal entries (AJE) are used to allocate revenues and expenses to the proper periods.

Example: Using the timeline below, Alpha received a bill for $600 in 2019 from the utilities company for water and electricity used during the two-month period December 2018 through January 2019.



However, prior to receiving the bill in 2019, Alpha needs to prepare its financial statements for the year ending December 31, 2018. If Alpha waits until the bill arrives in February of 2019 to record the $600, the utilities expense will be overstated for the year 2019 and understated for the year 2018 by one month of utilities. The use of utilities in December 2018 helps to produce revenues in 2018 and, therefore, must be expensed (matched to revenues) in that year. This is where the adjusting process is used. But how much do we record for December? Since the bill might not be received until after the financial statements are prepared, we really don't know. One approach would be to estimate the utilities used for December and expense it using an adjusting entry. If we estimate $250 based upon December utilities from last year, the following adjustment should be recorded:

Dec 31	Utilities Expense	250	
	Utilities (or Accounts) Payable		250

Why do we also record a liability for $250? The reason is because we have used one month of utilities and have created an obligation as of the end of 2018 to pay in the future even though the bill has not yet been received. So remember that adjusting journal entries involve both balance sheet and income statement accounts.

The economic events requiring adjusting entries are both continuous and internal, and most often will not be evidenced by new additional source documents. Therefore, the challenge is the task of identifying those events requiring adjustments. Examples of the more common revenues and expenses you might need to adjust are listed below.

ACCRUED REVENUES

Revenues earned but not yet collected or recorded.

- Professional Service Fees
- Sales
- Interest

DEFERRED REVENUES

Revenues collected in advance but not yet earned.

- Rent
- Service Fees
- Subscriptions

ACCRUED EXPENSES

Expenses incurred but not yet paid or recorded.

- Salaries
- Utilities
- Interest
- Income taxes

DEFERRED EXPENSES

Expenses prepaid but not yet incurred.

- Insurance
- Advertising
- Supplies
- Rent

In summary, adjusting journal entries are made at the end of the accounting period to update the accounts for internal transactions, and to make sure that the financial statements reflect all the events that occurred during a specific period, thereby ensuring the proper matching of revenues and expenses.

EXAMPLES OF ADJUSTING ENTRIES

1. ACCRUED REVENUE - A revenue that is earned but not yet collected or recorded.

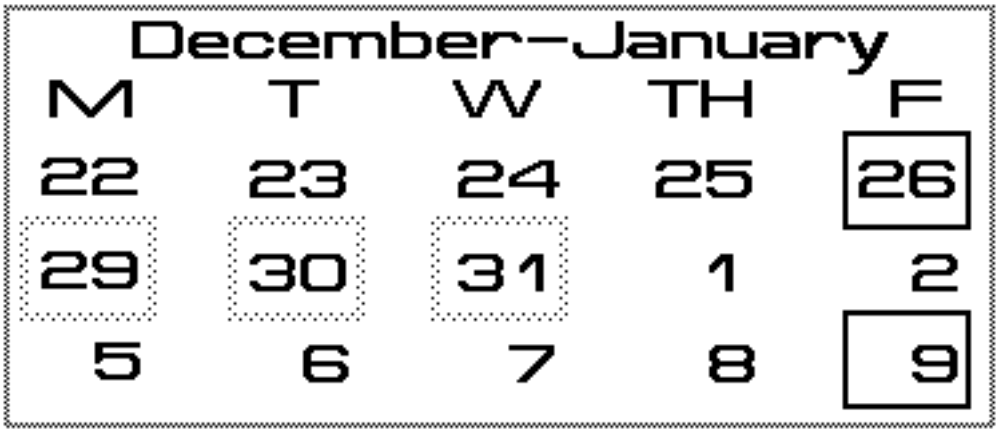
EXAMPLE: *ON DECEMBER 1, ALPHA MAKES A 60-DAY LOAN OF $4,000 TO ANOTHER COMPANY. ALPHA WILL RECEIVE INTEREST OF $100 AT THE END OF 60 DAYS.*

Observe that by the end of the year, Alpha has earned half of the interest even though Alpha won't receive the cash until the note matures in the following year. This interest won't be reported as revenue in the current year unless Alpha records the following adjusting journal entry:

Dec 31	Interest Receivable	50	
	Interest Revenue		50

2. ACCRUED EXPENSE - An expense that is incurred but not yet paid or recorded.

EXAMPLE: *ALPHA PAYS EMPLOYEE WAGES OF $5,000 PER WEEK. PAYCHECKS ARE ISSUED ON THE 2ND AND 4TH FRIDAY OF EACH MONTH. USING THE CALENDAR BELOW, THE LAST PAYDAY IN DECEMBER IS FRIDAY THE 26TH.*



There are three working days 29th, 30th, 31st) remaining in the current year in which labor was used to produce revenues. But this expense won't be recorded in the current year unless Alpha records the following adjusting journal entry:

Dec 31	Salaries Expense	3,000	
	Salaries Payable		3,000

3. DEFERRED REVENUE - A revenue that is collected in advance of being earned (recorded as a liability until earned).

EXAMPLE: *ON DECEMBER 1, ALPHA RENTS ONE OF ITS VACANT WAREHOUSES TO ANOTHER COMPANY FOR 6 MONTHS AT $1,000 PER MONTH. THE TOTAL RENT OF $6,000 IS RECEIVED IN ADVANCE.*

NOTE: Whenever cash is received in advance, it is recorded as a liability. Why? Because a promise is being made to provide goods or services in the future in return for receiving the cash in advance. This promise creates a liability. We refer to this liability by a very unusual but accurately descriptive name — Unearned Revenue. The original transaction on December 1 is recorded as follows:

Dec 1	Cash	6,000	
	Unearned Rent Revenue		6,000

By the end of the year, Alpha has earned one month of the rent that was received in advance. This rent won't be reported as revenue in the current year unless Alpha records the following adjusting journal entry:

Dec 31	Unearned Rent Revenue	1,000	
	Rent Revenue		1,000

Remember, the receipt of cash cannot be recognized as revenue until it is earned. Therefore, as long as it is unearned, it remains a liability. The type of unearned revenue should be included in the account name. In this example, "rent" is used.

4. DEFERRED EXPENSE - An expense that is paid in advance of being incurred (recorded as a prepaid asset until used).

EXAMPLE: *ON JANUARY 1, ALPHA PURCHASES A 3-YEAR INSURANCE POLICY FOR $3,000.*

By the end of the year, Alpha has used one year or $1,000 of the insurance that was prepaid. This insurance won't be reported as an expense in the current year unless Alpha records the following adjusting journal entry:

Dec 31	Insurance Expense	1,000	
	Prepaid Insurance		1,000

5. DEPRECIATION – Allocates the cost of an asset to future accounting periods in which the use of the asset will help produce revenues.

Example: Alpha purchases a $500 piece of equipment at the beginning of 2018 (the current year) that isexpected to have a useful life of 5 years (ignore salvage value).

Allocating the cost of this equipment equally over five years requires Alpha to record the following adjusting entry each year:

Dec 31	Depreciation Expense	100	
	Accumulated Depreciation		100

For each of the next five years, the asset section of the balance sheet reports the following:

Partial Balance Sheet

	2018	2019	2020	2021	2022
Equipment	500	500	500	500	500
Less: Accumulated Depreciation	100	200	300	400	500
Book value**	400	300	200	100	0

** This term is not used on the balance sheet.

NOTE: The account "Accumulated Depreciation" is called a **contra account**. A contra account is used to show a reduction of another account ("Equipment" in this example) without actually reducing the balance of that account. With the use of the contra account Accumulated Depreciation, we are able to continue to disclose the original (historical) cost of the asset on the balance sheet. The difference between the original cost and the accumulated depreciation is the asset's **book value**. Book value represents the cost of the asset that has not been used to produce revenues and, therefore, the remaining undepreciated cost. Book value is also used to find the gain or loss from the disposal of depreciable assets. A gain results if the proceeds received are greater than the book value, and a loss results if the proceeds received are less than book value.

REVERSING ENTRIES

Reversing entries are often used to simplify the recording of a transaction in the new accounting period that follows a related adjusting entry recorded in the old accounting period. There is no other purpose. A reversing entry is recorded by entering the exact reverse of an adjusting entry. Reversing entries will not be used in ACCT 350 unless you are directed otherwise.

Reversing entries are used to reverse adjusting entries only for accrued revenues, accrued expenses, prepayments that were originally recorded as expenses (rather than as prepaid assets), and cash received in advance that were originally recorded as revenues (rather than as liabilities).

Example: Refer back to the AJE for the accrued expense that was recorded for the remaining three working days as

DEC 31	SALARIES EXPENSE	3,000	
	SALARIES PAYABLE		3,000

On January 9 of the new year, Alpha pays its employees $10,000 and records the following entry:

JAN 9	SALARIES EXPENSE	7,000	
	SALARIES PAYABLE	3,000	
	CASH		10,000

Assume, however, that the bookkeeper is only familiar with recording the same journal entry every two weeks as

JAN 9	SALARIES EXPENSE	10,000	
	CASH		10,000

To make it easier on the bookkeeper, we record the following reversing entry dated January 1 in the new year. Notice that this entry is the exact reverse of the AJE recorded on December 31.

JAN 1	SALARIES PAYABLE	3,000	
	SALARIES EXPENSE		3,000

This reversing entry permits the bookkeeper to record the same entry as always on January 9.

JAN 9	SALARIES EXPENSE	10,000	
	CASH		10,000

The results are the same with or without the reversing entry as shown in the example below.

WITHOUT REVERSING ENTRY

JAN 9	SALARIES EXPENSE	7,000	
	SALARIES PAYABLE	3,000	
	CASH		10,000

WITH REVERSING ENTRY

JAN 1	SALARIES PAYABLE	3,000	
	SALARIES EXPENSE		3,000
JAN 9	SALARIES EXPENSE	10,000	
	CASH		10,000

If the two journal entries in the example on the right are combined, the result is the journal entry in the example on the left (after netting the debit and credit entries for Salaries Expense).

As indicated earlier, not all adjusting entries may be reversed.

NO

- DEFERRED REVENUES
- DEFERRED EXPENSES
- DEPRECIATION
- BAD DEBTS

YES

- ACCRUED REVENUES
- ACCRUED EXPENSES
- PREPAIDS RECORDED AS EXPENSES
- ADVANCES RECORDED AS REVENUES

CLOSING THE BOOKS

The income statement reports the results of operations for “a specific period of time” as net income (or net loss). Thus, net income (revenues minus expenses) measures the profitability of a business for only one accounting period at a time. As a result, all income statement accounts, referred to as **temporary** (or nominal) accounts, must begin each new accounting period with a “zero” balance in order to measure net income for only that period. Although the dividend account does not appear on an income statement, it is also a temporary account and is required to begin the new accounting period with a zero balance. [Note: Balance sheet accounts are referred to as **permanent** (or real) accounts, because the balances at the end of one accounting period are carried forward (rolled over) to become the beginning balances in the new accounting period.]

Each temporary account is closed to the Income Summary account, and the Income Summary account is then closed to the Retained Earnings account. In every computerized system, the accountant's work is greatly reduced. Instead of recording the closing entries manually, they are automatically recorded.

Example: The following trial balance represents the first year of operations for Alpha. Notice that the balance in the Retained Earnings account is zero because there is no net income in prior years and the current year's net income and dividends have not yet been closed and transferred to Retained Earnings.

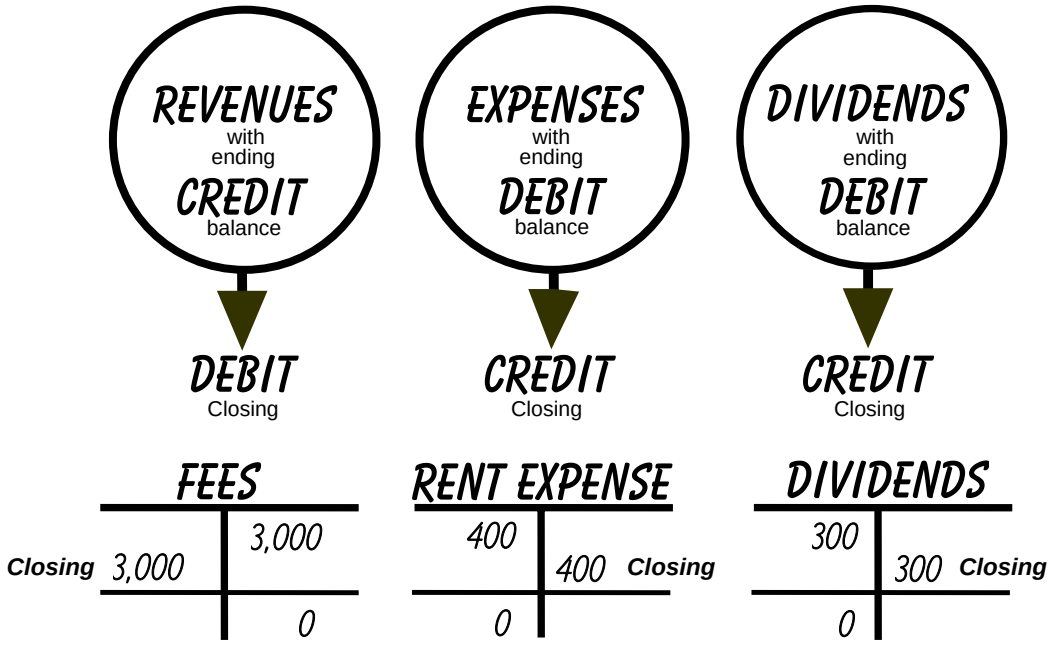
CASH	$ 700	
ACCOUNTS RECEIVABLE	1,500	
SUPPLIES	400	
ACCOUNTS PAYABLE		$ 300
CAPITAL STOCK		1,800
RETAINED EARNINGS		0
DIVIDENDS	300	
PROFESSIONAL SERVICE FEES		3,000
RENT EXPENSE	400	
SALARIES EXPENSE	1,000	
UTILITIES EXPENSE	500	
INCOME TAX EXPENSE	300	
TOTAL	$5,100	$5,100

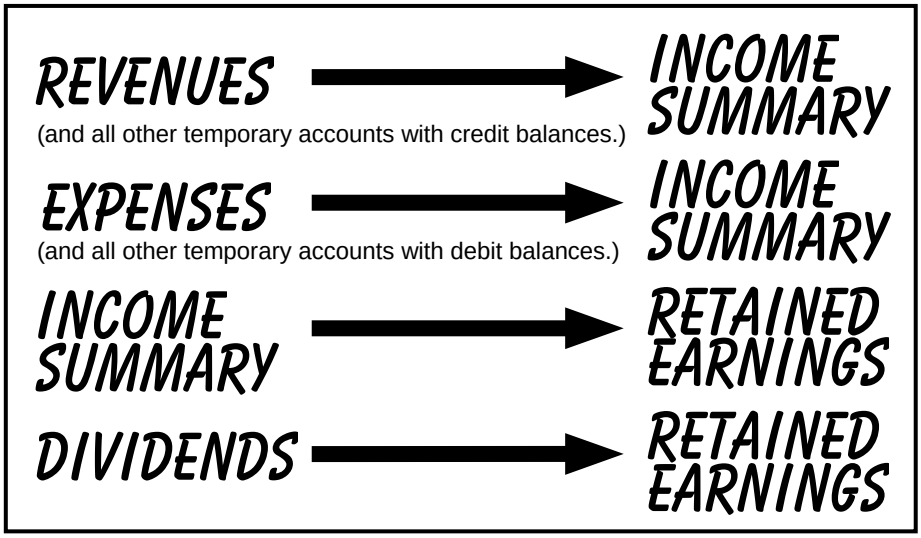
The closing entries are

1.	PROFESSIONAL SERVICE FEES	3,000	
	INCOME SUMMARY		3,000
2.	INCOME SUMMARY	2,200	
	RENT EXPENSE		400
	SALARIES EXPENSE		1,000
	UTILITIES EXPENSE		500
	INCOME TAX EXPENSE		300
3.	INCOME SUMMARY	800	
	RETAINED EARNINGS		800
4.	RETAINED EARNINGS	300	
	DIVIDENDS		300

Observe that the $800 transferred to Retained Earnings represents the net income for the year (revenues of $3,000 minus expenses of $2,200). After the closing process has been completed, the ending balance in Retained Earnings is $500 (net income of $800 minus dividends of $300). Also observe that the balances in the temporary accounts now have zero balances to begin the new accounting period in year two.

TO ZERO OUT THE OLD BALANCES





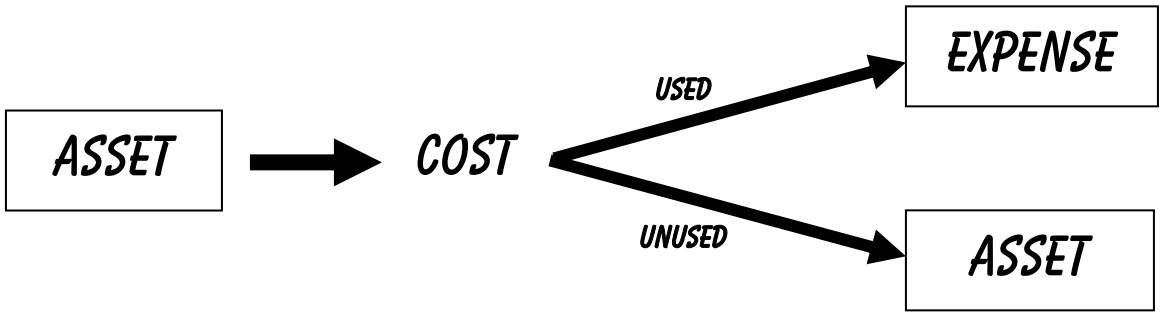
Remember, all accounts that appear on an income statement are temporary and must be closed. What this means is that temporary accounts are not limited to just revenues and expenses. The income statement also contains other temporary accounts such as Sales or Purchase Returns and Allowances, Sales or Purchase Discounts, and Purchases.

In summary, closing the temporary accounts serves two important functions:

1. Creates zero balances in all temporary accounts to begin the new accounting period.
2. Transfers revenues, expenses, and dividends (and all other temporary accounts) into retained earnings.

COST VERSUS EXPENSE

Students often confuse the terms “cost” and “expense” when first learning financial accounting. An asset is recorded at **cost**. Prepaid assets such as supplies, prepaid advertising, prepaid insurance, and prepaid rent remain a cost until used (either consumed physically or with the passage of time). When used, these costs become an **expense** because they have helped to produce a revenue. The same is true for depreciable assets. This is why two types of adjusting journal entries (deferred expenses and depreciation) need to be recorded at the end of an accounting period — to expense the cost of an asset that has been used to produce a revenue.



CONCLUSION

These two modules contain the basics that will be used in the first part of the MPAcc workshop.