

Simply Accounting by Sage

Accounting Manual

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Chapter 1

Listing the Things a Business Owns and Owes

This chapter discusses starting a company, and the relationship between the things a company owns and the money it owes.

Starting a Business

Jim Brown quits his job and starts his own company to do small construction contracts. The company is called National Construction and is a **proprietorship**. A proprietorship is a business which keeps accounting records separate from those of its owner but is not legally separate from its owner. On February 1, 1995, Brown deposits \$50,000 in National Construction's bank account.

The financial position of the company is a summary of **what it owns** and the **claims against the things that it owns** on the date of the summary. It can be compared to a snapshot that shows the position at a specific point in time.

National Construction February 1, 1995			
Things Owned:		Claims Against Things Owned:	
Cash in Bank	\$50,000	Jim Brown	\$50,000

On February 2, National Construction pays cash to buy a dump truck that costs \$10,000. This makes the company's list of things owned and claims against things owned look like this:

National Construction February 2, 1995			
Things Owned:		Claims Against Things Owned:	
Cash in Bank	\$40,000	Jim Brown	\$50,000
Truck	10,000		

Brown gets his first contract, but to complete it he needs to buy another truck. It costs \$12,000, and on February 3 he convinces his banker to lend National Construction the money to buy it. The loan is for a five-year term. National Construction now has more trucks, but a new category is needed to describe the bank's claim:

National Construction February 3, 1995			
Things Owned:		Claims Against Things Owned:	
Cash in Bank	\$40,000	Bank Loan	\$12,000
Trucks	22,000	Jim Brown	50,000

Everything the company owns was paid for with either the bank's money or the money invested by the owner. Notice that the value of the things owned equals the value of the claims against things owned. This relationship is always true, and is the basis for the entire accounting process:

Things Owned = Claims Against Things Owned

Let's look at another example. On February 4, National Construction buys \$1,000 worth of maintenance supplies for the trucks and the supplier gives National 30 days to pay. Amounts owed to a supplier who has given you credit are called accounts payable.

Here is the updated summary:

National Construction February 4, 1995			
Things Owned:		Claims Against Things Owned:	
Cash in Bank	\$40,000	Accounts Payable	\$ 1,000
Trucks	22,000	Bank Loan	12,000
Maintenance Supplies	<u>1,000</u>	Jim Brown	<u>50,000</u>
	63,000		63,000

"Things owned" still equal the "claims against things owned," and the changes which were made resulted in an increase of the same size to both the things owned and the claims against things owned. Because this summary always balances, we call this summary of things owned and claims against things owned a balance sheet. On the balance sheet, things owned are listed on the left, and claims against things owned on the right.

The claims against things owned are made by two groups of people: the owner, and others. In law, the owner does not get his investment back until others have been paid back. For this reason, it makes sense to break the claims into two groups, with claims by others ranked first:

National Construction Balance Sheet February 4, 1995			
Things Owned:		Claims Against Things Owned:	
Cash in Bank	\$ 40,000	Accounts Payable	\$ 1,000
Trucks	22,000	Bank Loan	<u>12,000</u>
Maintenance Supplies	<u>1,000</u>		13,000
	\$ 63,000	Claims by Owner:	
		Jim Brown	<u>50,000</u>
			\$ 63,000

You are now ready to go to Chapter 2 to find out more about the balance sheet.

Chapter 2

The Balance Sheet

This chapter discusses a company's assets, liabilities, and equity, and shows how changes in any one of these affect the other two.

Assets, Liabilities and Equity

Things owned by the company are called **assets**. Claims by others are called **liabilities**. If the owner wants to get back his investment, he must sell the assets and pay off the liabilities. What is left over is the owner's **equity** in the company. The balance sheet is now presented with the new words:

National Construction Balance Sheet February 4, 1995			
Assets:		Liabilities:	
Cash in Bank	\$ 40,000	Accounts Payable	\$ 1,000
Trucks	22,000	Bank Loan	<u>12,000</u>
Maintenance Supplies	<u>1,000</u>		<u>13,000</u>
	<u>\$ 63,000</u>	Equity:	
		Jim Brown	<u>50,000</u>
			<u>\$ 63,000</u>

Our statement "Things Owned = Claims Against Things Owned" can now be rewritten:

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

This statement is the basis of accounting and is accounting's single most important concept. It is called the accounting equation.

Changes in Assets, Liabilities and Equity

Since assets equal liabilities plus equity, we know that if assets increase, then liabilities plus equity must increase by the same amount. The accounting equation can also be used to say that changes in assets equal changes in liabilities plus changes in equity.

Here are some more examples so we can see how assets, liabilities, and equity are related.

On February 5, National Construction buys some furniture costing \$2,000 for the office Jim Brown has set up in his home. The supplier gives National 30 days to pay the bill. Our updated balance sheet has a new asset called furniture, and accounts payable has increased by the amount of the supplier's bill:

National Construction Balance Sheet February 5, 1995			
Assets:		Liabilities:	
Cash in Bank	\$ 40,000	Accounts Payable	\$ 3,000
Trucks	22,000	Bank Loan	<u>12,000</u>
Maintenance Supplies	1,000		<u>15,000</u>
Furniture	<u>2,000</u>	Equity:	
	\$ <u>65,000</u>	Jim Brown	<u>50,000</u>
			\$ <u>65,000</u>

On February 7, National buys a front-end loader which costs \$20,000, but this time the bank will only lend \$15,000 and the company must make a down payment of \$5,000. Because Brown expects to buy more equipment related to construction, he categorizes the front-end loader as Construction Equipment and puts a value of \$20,000 beside it.

He also records the decrease in Cash in Bank of \$5,000 (to \$35,000) and the increase in the Bank Loan of \$15,000 (to \$27,000):

National Construction Balance Sheet February 7, 1995			
Assets:		Liabilities:	
Cash in Bank	\$ 35,000	Accounts Payable	\$ 3,000
Trucks	22,000	Bank Loan	<u>27,000</u>
Maintenance Supplies	1,000		<u>30,000</u>
Furniture	2,000	Equity:	
Construction Equipment	<u>20,000</u>	Jim Brown	<u>50,000</u>
	\$ <u>80,000</u>		\$ <u>80,000</u>

You are now ready to go to Chapter 3 to find out more about changes in withdrawals, earnings, and losses.

Chapter 3

Changes in Equity

There are two ways for equity to change. They are **investments** or **withdrawals** by the owner, and **earnings** or **losses** by the company. We have already covered investments by the owner, so this section will now cover withdrawals, earnings, and losses.

Changes Caused by Withdrawals

On February 22, Brown needs \$2,000 to repair the family car and takes it out of the company's bank account because he doesn't have enough money personally. When a proprietor takes money out of his business, it is called a **withdrawal**.

The Cash in Bank category goes down by \$2,000 (to \$33,000) and the equity category goes down by \$2,000 (to \$48,000):

National Construction Balance Sheet February 22, 1995			
Assets:		Liabilities:	
Cash in Bank	\$ 33,000	Accounts Payable	\$ 3,000
Trucks	22,000	Bank Loan	<u>27,000</u>
Maintenance Supplies	1,000		<u>30,000</u>
Furniture	2,000	Equity:	
Construction Equipment	<u>20,000</u>	Jim Brown	<u>48,000</u>
	\$ <u>78,000</u>		\$ <u>78,000</u>

Changes Caused by Earnings

Brown completes his first gravel hauling contract on February 27 and National Construction is paid \$5,000 cash. The Cash in Bank category therefore increases by \$5,000 to \$38,000.

The client paid for the gas, so the hauling contract didn't cost National anything except Brown's time. This means that National doesn't owe any of the money to anyone else, and therefore earned the entire \$5,000. Now Brown has to decide where to record the money that the company earned.

Since assets increased by \$5,000 (cash was received), and the amount of liabilities didn't change (National doesn't owe anyone anything extra as a result of earning the \$5,000), we know that equity must increase by \$5,000 in order to keep the accounting equation in balance.

This increase in equity was **earned** by the company, not invested by the owner, so we show it as a separate category of equity called Earnings.

National Construction Balance Sheet February 27, 1995			
Assets:		Liabilities:	
Cash in Bank	\$ 38,000	Accounts Payable	\$ 3,000
Trucks	22,000	Bank Loan	<u>27,000</u>
Maintenance Supplies	1,000		<u>30,000</u>
Furniture	2,000	Equity:	
Construction Equipment	<u>20,000</u>	Jim Brown	48,000
	\$ <u>83,000</u>	Earnings	<u>5,000</u>
			<u>53,000</u>
			\$ <u>83,000</u>

If the company lost money in the future, the losses would reduce the amount of the earnings by the amount of the loss.

For the same reasons that earnings has its own category, withdrawals could also have its own category. It has not been added at this point, though, in order to keep the balance sheet relatively uncluttered.

You are now ready to go to Chapter 4 to find out about revenues and expenses.

Chapter 4

Recording How Earnings Were Made

This chapter tells you how to record the money a company takes in for the goods and services it provides for its customers, and the money it spends to provide those goods and services.

Revenues and Expenses

Brown completes an excavating contract on March 1 for which National is paid \$6,000 cash. This time he has to pay an equipment operator \$2,000 in wages, which is paid in cash on March 1.

National took in \$6,000 cash and paid out \$2,000 in cash. Cash in Bank therefore increases by \$4,000 (to \$42,000). Again, liabilities didn't increase as a result of the contract, so the earnings section of equity on the balance sheet increases by \$4,000 (to \$9,000) to keep it balanced.

Brown can now update his balance sheet for the increase of \$4,000 in Cash in Bank (to \$42,000) and the \$4,000 increase in earnings (to \$9,000) and be correct, but he will have left out some very useful and important information. He will not be able to see on the balance sheet how much cash was received and spent in order to earn the \$4,000.

To show this on the balance sheet, he breaks the earnings category into two parts, **revenues**, and **expenses**; which he uses to show how much money the company took in and paid out in order to earn the total of \$9,000.

Revenues are the money a company is paid, or expects to be paid, for goods or services it provides to its customers. The word **Sales** is sometimes used in its place for a company that sells products instead of services. National was paid \$5,000 for

the hauling contract and \$6,000 for the excavating contract. Its total revenues are therefore \$11,000.

Expenses are the amount a company spends to provide goods or services to its customers. National's only expenses for the contracts are \$2,000 in wages. Earnings are what is left over after expenses are deducted from revenues.

Brown can now update his balance sheet to show the increases in Cash in Bank and Earnings, as well as show how the earnings were earned.

He does not have to record the fact that he earned \$4,000 for this last contract directly (\$6,000 revenues minus \$2,000 expenses), because after expenses are subtracted from revenues within the earnings category of the balance sheet, this increase of \$4,000 in earnings will have been taken into account automatically:

National Construction Balance Sheet March 1, 1995			
Assets:		Liabilities:	
Cash in Bank	\$ 42,000	Accounts Payable	\$ 3,000
Trucks	22,000	Bank Loan	<u>27,000</u>
Maintenance Supplies	1,000		<u>30,000</u>
Furniture	2,000	Equity:	
Construction Equipment	<u>20,000</u>	Jim Brown	48,000
	\$ <u>87,000</u>	Earnings	
		Revenues:	
		Hauling	\$ 5,000
		Excavating	<u>6,000</u>
			11,000
		Expenses:	
		Wages	<u>2,000</u>
		Earnings	<u>9,000</u>
			<u>57,000</u>
			\$ <u>87,000</u>

When to Record Revenues and Expenses

Revenue is recorded in the financial records at the time the title or ownership of the goods or services passes to the customer. For a company that provides services, this usually means when the services or the contract for the services are completed.

This means that National doesn't actually have to be paid for the revenue in order to record the revenue on its balance sheet. It just has to complete the contract and bill the customer. The amount receivable from a customer for goods or services is an asset (it is actually a promise to pay in cash) called an **account receivable**.

Expenses are recorded in the financial records either at the time they are incurred (for example, advertising), or if they can be matched to a certain good or service provided (for example, wages for a particular contract). The matching of expenses with the revenues that they helped generate is called the **matching concept**.

This means that National doesn't have to pay for an expense to be able to record the expense on its balance sheet. It just has to incur the expense and then record the amount owed to someone for the expense as an account payable.

Brown completes another hauling contract on March 3 for which National will be paid \$3,000 within 30 days. His expenses are \$2,000 in wages which he pays on March 3 out of cash.

The \$3,000 owed to National by the customer is an account receivable, so Brown sets up an asset category with that name and assigns it \$3,000. At the same time, he increases Hauling Revenue by \$3,000 (to \$8,000) because it is the source of the account receivable.

He records revenue now, even though National hasn't yet been paid, because for service contracts, revenue is recorded when the contract is completed.

His expenses for the contract are \$2,000 in wages so he increases Wage Expense by this amount (to \$4,000). He records it now

because he has already recorded revenue, and wants to match the expenses for the contract with the revenue for the contract. At the same time, he decreases Cash in Bank by \$2,000 (to \$40,000) to record the payment of the wages.

National Construction Balance Sheet March 3, 1995			
Assets:		Liabilities:	
Cash in Bank	\$ 40,000	Accounts Payable	\$ 3,000
Trucks	22,000	Bank Loan	<u>27,000</u>
Maintenance Supplies	1,000		<u>30,000</u>
Furniture	2,000	Equity:	
Construction Equipment	20,000	Jim Brown	48,000
Accounts Receivable	<u>3,000</u>	Earnings	
	\$ <u>88,000</u>	Revenues:	
		Hauling	\$ 8,000
		Excavating	<u>6,000</u>
			14,000
		Expenses:	
		Wages	<u>4,000</u>
		Earnings	<u>10,000</u>
			<u>58,000</u>
			\$ <u>88,000</u>

You are now ready to go to Chapter 5 to learn more about recording changes to the balance sheet.

Chapter 5

Recording Changes to the Balance Sheet

In this chapter, you will learn why you record revenues and expenses when they are earned, rather than when they are actually received and paid. You will also learn how to use debits and credits to record changes to the balance sheet.

Recording Transactions

Brown can use the version of the balance sheet in Chapter 4 to record any changes caused by transactions. A transaction is the exchange of something of value (cash, a service) for something else of value (a truck, a promise to pay). All the changes recorded between February 1 and March 3 have been due to transactions.

National Construction's next completed project is an excavation contract. On March 5, Brown bills the customer the full amount of \$3,000 and pays \$2,000 cash to the subcontractor who did the work and \$500 cash for wages to his employee who supervised the work. These are two transactions. The first bills the customer and the second pays the subcontractor and employee.

To record these transactions, he deals with each one separately.

Brown increases Accounts Receivable by \$3,000 (to \$6,000) and increases Excavating Revenue by \$3,000 (to \$9,000). He records the revenue now because the job is complete.

He decreases Cash in Bank by \$2,500 (to \$37,500), increases Wage Expense by \$500 (to \$4,500), and sets up a new category called Subcontracts Expenses for \$2,000. He records the

expenses now because he wants to match them to the revenue that he has already recorded.

Finished recording, he totals the balance sheet again, with the following result:

National Construction Balance Sheet March 5, 1995			
Assets:		Liabilities:	
Cash in Bank	\$ 37,500	Accounts Payable	\$ 3,000
Trucks	22,000	Bank Loan	27,000
Maintenance Supplies	1,000		<u>30,000</u>
Furniture	2,000	Equity:	
Construction Equipment	20,000	Jim Brown	48,000
Accounts Receivable	<u>6,000</u>	Earnings	
	\$ <u>88,500</u>	Revenues:	
		Hauling \$	8,000
		Excavating	<u>9,000</u>
			17,000
		Expenses:	
		Wages	4,500
		Subcontracts	<u>2,000</u>
			<u>6,500</u>
		Earnings	<u>10,500</u>
			<u>58,500</u>
			\$ <u>88,500</u>

On March 6, National receives the \$3,000 owed from the hauling contract completed on March 3. Brown had accounted for the money owed to National by increasing Accounts Receivable by \$3,000. Now that National has been paid, Brown must reduce Accounts Receivable by \$3,000 (to \$3,000), and increase Cash in Bank by \$3,000 (to \$40,500).

Notice that National was paid the \$3,000 that it was owed for the contract, but that no revenue or earnings were recorded as a result of this payment. **This is because the revenue was recorded at the time the contract was completed.**

National is now simply recording the payment of an amount owed to it. The act of collecting cash owed reduces Accounts Receivable and increases Cash in Bank, but does not increase

National's earnings. Do not confuse the collection of cash with the earnings earned by providing the goods or services.

This method of accounting for revenue and expenses when they are earned or incurred, rather than when the cash is actually received or paid, is called the **accrual method**. It is one of the main principles of accounting. The goal of the accrual method is to accurately match earnings with the events that resulted in the earnings. These events are the generation of revenue and the incurring of expenses, not the collection of accounts receivable and the payment of accounts payable.

This is why revenues and expenses are recorded when they are earned or incurred, rather than when they are received or paid.

The categories under Assets, Liabilities, Equity, Revenues and Expenses are called **accounts**, and that word will be used from now on. The value assigned to any account (such as Furniture \$2,000) is called the **account balance**, or balance for short.

Also, on March 6, Brown pays for the maintenance supplies (\$1,000) and furniture (\$2,000) purchased earlier on credit. He therefore reduces the balance of the Cash in Bank account by \$3,000 (to \$37,500) and the Accounts Payable account by \$3,000 (to zero):

National Construction Balance Sheet March 6, 1995			
Assets:		Liabilities:	
Cash in Bank	\$ 37,500	Bank Loan	\$ <u>27,000</u>
Trucks	22,000		
Maintenance Supplies	1,000		
Furniture	2,000	Equity:	
Construction Equipment	20,000	Jim Brown	48,000
Accounts Receivable	<u>3,000</u>	Earnings	
	\$ <u>85,500</u>	Revenues:	
		Hauling	8,000
		Excavating	<u>9,000</u>
			17,000
		Expenses:	
		Wages	4,500
		Subcontracts	<u>2,000</u>
			<u>6,500</u>
		Earnings	<u>10,500</u>
			<u>58,500</u>
			\$ <u>85,500</u>

On the same day, he gets an invoice for a truck tune-up (\$200) and a telephone bill (\$100), and interest on National's bank loan is taken out of the company's bank account by the bank (\$400).

He increases Accounts Payable by \$300 (to \$300), decreases Cash in Bank by \$400 (to \$37,100), and at the same time sets up a Maintenance expense account for \$200, a Telephone expense account for \$100 and an Interest expense account for \$400.

Finished recording, he now totals the balance sheet again:

National Construction Balance Sheet March 6, 1995			
Assets:		Liabilities:	
Cash in Bank	\$ 37,100	Accounts Payable	\$ 300
Trucks	22,000	Bank Loan	<u>27,000</u>
Maintenance Supplies	1,000		<u>27,300</u>
Furniture	2,000	Equity:	
Construction Equipment	20,000	Jim Brown	48,000
Accounts Receivable	<u>3,000</u>	Earnings	
	\$ <u>85,100</u>	Revenues:	
		Hauling	8,000
		Excavating	<u>9,000</u>
			17,000
		Expenses:	
		Wages	4,500
		Subcontracts	2,000
		Telephone	100
		Maintenance	200
		Interest	<u>400</u>
			<u>7,200</u>
		Earnings	<u>9,800</u>
			<u>57,800</u>
			\$ <u>85,100</u>

Debits and Credits

Over time, an easy-to-use and logical system has developed to record any changes to a balance sheet. It will be used from now on to explain how to record changes to National's balance sheet.

The system involves using the words **debit** and **credit**, which we will now define.

First, it is important to know that any of the accounts can be on the left or right side of the balance sheet. Because this is true, the account names could be put in one vertical column, and the account balances that pertain to each could be placed on the left or right side of the balance sheet beside them. Accounts then can have either a left or right balance.

Debit refers to the left side of an account and credit refers to the right side of an account. Similarly, accounts which have balances on the left side of a balance sheet have debit balances, and accounts which have balances on the right side of a balance sheet have credit balances.

Do not place any additional meanings on these words. In the practice of accounting, these two words refer only to the left (debit) and right (credit) sides of an account.

Asset accounts are on the left side of a balance sheet and therefore have debit balances. Liability and equity accounts are on the right side of a balance sheet and therefore have credit balances.

The statement on the next page is National's balance sheet, but we have set up each account so that it can have either a left (debit) or right (credit) balance.

For each account, we have put its balance on either the debit or credit side of the account, whichever is correct for that particular account. Because we usually rank revenues and expenses vertically, we have left them out temporarily and only show Earnings in their place.

Notice that the total of the debit balances equals the total of the credit balances. We expect this, since this is just another way of saying that assets equal liabilities plus equity. It is also true then that if we make any changes to a balance sheet, the total amount of the debit changes equals the total amount of the credit changes.

National Construction Trial Balance March 6, 1995		
	Debit Balance	Credit Balance
Cash in Bank	37,100	
Trucks	22,000	
Maintenance Supplies	1,000	
Furniture	2,000	
Construction Equipment	20,000	
Accounts Receivable	3,000	
Accounts Payable		300
Bank Loan		27,000
Jim Brown		48,000
Earnings		<u>9,800</u>
	85,100	85,100

Notice that it is possible for asset accounts to have credit balances (as long as the balance sheet still balances). For instance, if Cash in Bank had a credit balance of \$3,000, it would mean that you were overdrawn at the bank by \$3,000. Cash in Bank would still be shown as an asset, but the account balance displayed beside it would have a negative sign beside it.

The act of increasing the account balance of an account that has a debit balance is called **debiting**. Instead of saying "debiting the account," we could say "debit the account."

The act of increasing the account balance of an account that has a credit balance is called **crediting**. Instead of saying "crediting the account," we could say "credit the account."

To decrease the account balance of an account that has a debit balance, we would do the opposite of what we would do to increase it, and therefore credit the account.

Summary of Debit and Credit Theory							
Assets		=	Liabilities		+	Equity	
Asset Accounts			Liability Accounts			Equity Accounts	
<hr/>			<hr/>			<hr/>	
Debit to	Credit to		Debit to	Credit to		Debit to	Credit to
+	-		-	+		-	+

Similarly, to decrease the account balance of an account that has a credit balance, we would debit it.

Debits and Credits on the Balance Sheet

On March 7, National Construction receives \$3,000 cash which was receivable for its first contract. To record this, Brown debits the Cash in Bank account by \$3,000 to record the increase (to \$40,100) and credits the Accounts Receivable account by \$3,000 to record the decrease (to zero).

On the same day, he pays his truck tune-up bill of \$200. To record this, he debits the Accounts Payable account by \$200 to record the decrease (to \$100) and credits the Cash in the Bank account by \$200 to record the decrease (to \$39,900).

Finished recording, he totals the balance sheet again.

National Construction Balance Sheet March 7, 1995			
Assets:		Liabilities:	
Cash in Bank	\$ 39,900	Accounts Payable	\$ 100
Trucks	22,000	Bank Loan	<u>27,000</u>
Maintenance Supplies	1,000		<u>27,100</u>
Furniture	2,000	Equity:	
Construction Equipment	<u>20,000</u>	Jim Brown	48,000
	\$ <u>84,900</u>	Earnings	
		Revenues:	
		Hauling	8,000
		Excavating	<u>9,000</u>
			17,000
		Expenses:	
		Wages	4,500
		Subcontracts	2,000
		Telephone	100
		Maintenance	200
		Interest	<u>400</u>
			<u>7,200</u>
		Earnings	<u>9,800</u>
			<u>57,800</u>
			\$ <u>84,900</u>

Revenues and Expenses

The debit and credit system also works for revenues and expenses, but since we place these accounts vertically on the balance sheet instead of on the left and right, more explanation is required.

As explained earlier, to increase the balance of an equity account (invested capital or earnings) we credit it. Increases in revenue increase the company's earnings, and therefore increase the equity in the company. Additional revenues should therefore be recorded as credits to revenue accounts, and revenue accounts would normally have credit balances.

Similarly, to decrease the balance of an equity account (invested capital or earnings) we debit it. Increases in expense decrease the company's earnings, and therefore decrease the equity in the company. Additional expenses should therefore be recorded as debits to expense accounts, and expense accounts would normally have debit balances.

Here is an example. On March 15, Brown completes another excavating contract for \$7,000, for which National Construction will be paid in 30 days. His expenses are a subcontractor (\$5,000, payable in 30 days) and his crew supervisor's wages (\$1,000, paid in cash on March 15).

To record the completion of this contract and the related transactions, Brown first debits Accounts Receivable by \$7,000 to record the increase (to \$7,000) and credits Excavating revenue by \$7,000 to record the increase (to \$16,000), since it was the source of the account receivable.

He then debits Subcontracts expenses by \$5,000 to record the increase (to \$7,000) and credits Accounts Payable by \$5,000 to record the increase (to \$5,100).

He then debits Wage expense by \$1,000 to record the increase (to \$5,500) and credits Cash in Bank by \$1,000 to record the decrease because the wages have been paid.

Finished recording, he totals the balance sheet again with the following result:

National Construction Balance Sheet March 15, 1995			
Assets:		Liabilities:	
Cash in Bank	\$ 38,900	Accounts Payable	\$ 5,100
Trucks	22,000	Bank Loan	<u>27,000</u>
Maintenance Supplies	1,000		<u>32,100</u>
Furniture	2,000	Equity:	
Construction Equipment	20,000	Jim Brown	48,000
Accounts Receivable	<u>7,000</u>	Earnings	
	\$ <u>90,900</u>	Revenues:	
		Hauling	\$ 8,000
		Excavating	<u>16,000</u>
			24,000
		Expenses:	
		Wages	5,500
		Subcontracts	7,000
		Telephone	100
		Maintenance	200
		Interest	<u>400</u>
			<u>13,200</u>
		Earnings	<u>10,800</u>
			<u>58,800</u>
			\$ <u>90,900</u>

You are now ready to go to Chapter 6 to learn more about the income statement.

Chapter 6

A Separate Income Statement

This chapter introduces the income statement, telling you why it is necessary and how it works.

Why and How

A statement which shows revenues, expenses, and the resulting net income for a business over any particular period of time is called an **income statement**. Net income is total revenues minus total expenses for a particular period of time. For instance, if someone says that a job provides an income of \$6,000, it is important to know if that is the monthly income or the annual income. Income is also called net income, profit and net profit.

The reason for having a separate income statement is that it provides information on how the earnings on the balance sheet were arrived at and over what period of time.

As National Construction has only been in business for a short time, the earnings on the balance sheet reflect exactly the net income from the income statement for the year to date.

National Construction Balance Sheet March 15, 1995			
Assets:		Liabilities:	
Cash in Bank	\$ 38,900	Accounts Payable	\$ 5,100
Trucks	22,000	Bank Loan	<u>27,000</u>
Maintenance Supplies	1,000		<u>32,100</u>
Furniture	2,000	Equity:	
Construction Equipment	20,000	Jim Brown	48,000
Accounts Receivable	<u>7,000</u>	Earnings	<u>10,800</u>
	\$ <u>90,900</u>		<u>58,800</u>
			\$ <u>90,900</u>

National Construction Income Statement Feb 1 - Mar 15, 1995		
Revenues		
Hauling	\$ 8,000	
Excavating	<u>16,000</u>	
	\$ 24,000	
Expenses		
Wages	5,500	
Subcontracts	7,000	
Telephone	100	
Maintenance	200	
Interest – Bank Loan	<u>400</u>	
	13,200	
Net Income		\$ <u>10,800</u>

Note that the Net Income on the income statement equals the Earnings on the balance sheet.

Debits and Credits Affect Both Statements

Each time a debit or credit is made to a revenue or expense account, net income for the year must be recalculated and this new income figure must be put into the balance sheet. As long as changes that are recorded to the balance sheet and income statement have debits and credits of equal value, the balance sheet will always balance and the Net Income/Earnings figures on the two statements will be the same.

After the business year is over, the Earnings section of the balance sheet will have two accounts: Previous Years' Earnings; and Current Year's Earnings.

The Current Year's Earnings will be the same as the Net Income on the income statement for the business year to date. Previous Years' Earnings will be the total of all Earnings since the business was started, except for the portion shown as Current Year's Earnings. The debits and credits necessary to implement this change at the end of a business year will be covered later.

Except for adding more accounts (for extra information or new transactions) and perhaps reorganizing accounts so that they are grouped into summaries (we might break down Subcontracts Expense by types, each one with its own account), the balance sheet and income statement (the **financial statements**) provide the basic financial information on the company.

You are now ready to go to Chapter 7 to learn more about the journal.

Chapter 7

The Journal

In this chapter, you will learn how a company uses the journal to keep track of all its business transactions.

Why and How

Brown's statements provide financial information in a useful and understandable way, but he still has a problem. If he compares his balance sheet of February 1 with his current balance sheet, he sees that Accounts Payable has increased by \$5,100.

He doesn't know when it increased, how large the balance got, how fast it increased, or if he's ever paid any of his suppliers. He also doesn't have any of the historical data (past transactions that were recorded) on any of the other accounts.

This being the case, he sets up a book in which to list by date all the transactions he has recorded in his financial statements. Such a book is called a **journal** or **general journal**.

The journal is a company's primary record of all its business transactions. Transactions are recorded in the journal before they are recorded on the financial statements. This is to ensure that there is a record of the cause of any changes to the financial statements before the financial statements are prepared, after which the cause might not be traceable.

For each transaction to be recorded in the journal Brown needs to know the date, who is involved (customer, employee, and so on), if money was received, paid or earned, and the activity that resulted in the transaction.

Then he can determine the amount of the debits and credits, which accounts got debited and credited, and a short

description of the transaction being recorded, which might reference an invoice number or another document related to the transaction (this is sometimes called a **source** document).

A journal entry covering, for example, Brown's initial injection of capital into the company, might look like this:

National Construction Journal					
No.	Date	Particulars	#	Debit	Credit
1	Feb 1, 95	Cash in Bank Jim Brown Owner invested money in company	1020 3300	50,000	50,000

Such an entry is called a **journal entry**. As mentioned earlier, but using different words, for each journal entry the total value of the debits must equal the total value of the credits, otherwise the financial statements will not balance. When making a journal entry, it is common practice to list all the debits above the credits and leave the dollar signs out.

The numbers 1020 and 3300 in the "#" column are **account numbers**, which have been assigned to reduce errors such as debiting or crediting accounts with similar names. A **chart of accounts** is a list of all the accounts by their account number. It functions like an index for a book.

For National Construction, asset accounts are assigned account numbers from 1000-1999, liability accounts are assigned numbers from 2000-2999, equity accounts are assigned numbers from 3000-3999, revenue accounts are assigned numbers from 4000-4999 and expense accounts are assigned numbers from 5000-5999.

Here is National Construction's chart of accounts:

National Construction Chart of Accounts March 15, 1995	
1020	Cash in Bank
1200	Accounts Receivable
1400	Maintenance Supplies
1600	Trucks
1650	Construction Equipment
1700	Furniture
2080	Accounts Payable
2500	Bank Loan
3300	Jim Brown's Invested Capital
3600	Current Earnings
4100	Hauling Revenue
4200	Excavating Revenue
5020	Wage Expense
5040	Subcontracts Expense
5080	Maintenance Expense
5160	Interest Expense
5220	Telephone Expense

National Construction's Journal

Here is the complete journal for National Construction from February 1 to March 15. Revenues and expenses are recorded when they were actually earned or incurred, not added as a breakdown of income as they were earlier when we developed the model. To make it easy to refer to specific journal entries, the entries are numbered sequentially as they are made.

National Construction Journal					
No.	Date	Particulars	#	Debit	Credit
1	Feb 1, 95	Cash in Bank Jim Brown Owner invested in company	1020 3300	50,000	50,000
2	Feb 2, 95	Trucks Cash in Bank	1600 1020	10,000	10,000
3	Feb 3, 95	Bought TR39 Dump Truck Trucks Bank Loan	1600 2500	12,000	12,000
4	Feb 4, 95	Bought TR41, bank financed Maintenance Supplies Accounts Payable	1400 2080	1,000	1,000
5	Feb 5, 95	For trucks, from Apollo Auto. Furniture Accounts Payable	1700 2080	2,000	2,000
6	Feb 7, 95	For office, Western Furniture Construction Equipment Bank Loan Cash in Bank	1650 2500 1020	20,000	15,000 5,000
7	Feb 22, 95	Front end loader, loan with bank Jim Brown Cash in Bank	3300 1020	2,000	2,000
8	Feb 27, 95	Owner took cash out of company Cash in Bank Hauling Revenue	1020 4100	5,000	5,000
9	Mar 1, 95	Pool contract completed. Paid. Cash in Bank Excavating Revenue Basement: invoice #1002	1020 4200	6,000	6,000
10		Wage Expense Cash in Bank Basement, Jones paid	5020 1020	2,000	2,000
11		Accounts Receivable Hauling Revenue Tunnel: invoice #1003	1200 4100	3,000	3,000

National Construction Journal					
No.	Date	Particulars	#	Debit	Credit
12	Mar 3, 95	Wage Expense Cash in Bank Tunnel, Jones paid	5020 1020	2,000	2,000
13	Mar 5, 95	Accounts Receivable Excavating Revenue House: invoice #1004	1200 4200	3,000	3,000
14	Mar 5, 95	Subcontracts Expense Wage Expense Cash in Bank House: invoice #1004	5040 5020 1020	2,000 500	2,500
15	Mar 6, 95	Cash in Bank Accounts Receivable Invoice #1003 paid	1020 1200	3,000	3000
16	Mar 6, 95	Accounts Payable Cash in Bank Paid for furniture, supplies	2080 1020	3,000	3,000
17	Mar 6, 95	Maintenance Expense Telephone Expense Interest Expense-Bank Loan Cash in Bank Accounts payable	5080 5220 5160 1020 2080	200 100 400	400 300
18	Mar 7, 95	Bills received, interest paid Cash in Bank Accounts Receivable Payment for invoice #1001	1020 1200	3,000	3,000
19	Mar 7, 95	Accounts Payable Cash in Bank Truck tune-up paid	2080 1020	200	200
20	Mar 15, 95	Accounts Receivable Excavating Revenue Apartment, invoice #1000	1200 4200	7,000	7,000
21	Mar 15, 95	Subcontracts Expense Wage Expense Accounts Payable Cash in Bank Apartment, Jones paid	5040 5020 2080 1020	5,000 1,000	5,000 1,000

Chapter 8

The Ledger

This chapter tells you why you use a ledger, and how it keeps track of detailed account information.

Why and How

Brown is now able to determine exactly how the Accounts Payable balance got to its current level of \$5,100 by looking through the journal. This could take a lot of time, and he can find this information more quickly if he sets up another book called the **ledger**, in which each page is a detailed record of one account (for example, Accounts Payable).

For each account (sometimes called a **ledger account**) he records the debits and credits that were recorded in the journal and affect the account, the date of the debits and credits, and the ending account balance. Now, each time he makes a journal entry, he also records the debits and credits that he entered into the journal into the ledger accounts that were affected.

A ledger account might look like this for Accounts Payable:

ACCOUNT: ACCOUNTS PAYABLE			#2080		
Date	Reference	Debits	Credits	Debit Balance	Credit Balance
Feb 4, 95	J4		1,000		1,000
Feb 5, 95	J5		2,000		3,000
Mar 6, 95	J16	3,000			0
Mar 6, 95	J17		300		300
Mar 6, 95	J19	200			100
Mar 15, 95	J21		5,000		5,100

Posting

The "reference" provides the journal number where the journal entry which uses this account may be viewed in its entirety.

The process of transferring information from the journal to the applicable ledger account is called **posting**.

Between National Construction's financial statements, journal and ledger, Brown can very quickly determine National's position, and the history behind any value summarized on the income statement or balance sheet.

Now when a transaction occurs and Brown wants to update his financial statements, he makes an entry in his journal to record the transaction, posts the debits and credits to the correct accounts in the ledger, and prepares National Construction's balance sheet and income statement by using the account balances in his ledger.

Then, after determining income on the income statement, he adds it to the Earnings section of equity on the balance sheet where it causes the balance sheet to balance.

Obviously, this is a lot of work to do each time a transaction is recorded. That's why we have computers.

Chapter 9

Manual Accounting Systems

Standard manual accounting systems follow the same basic flow of information as the system used by National Construction, except that journal entries are posted to the ledger accounts in batches, usually at the end of every month.

The debit and credit balances of all the accounts in the ledger are then totaled and compared to ensure that there have been no posting or adding mistakes and that total debits equal total credits. This is called a **trial balance**.

Income is determined and moved to the earnings section of the balance sheet (to cause it to balance) on a **worksheet**. This is a large sheet of paper that vertically ranks every account in the ledger, to make the determination of income and the adjustment of the earnings section of the balance sheet easy to follow.

The account balances on the worksheet are then used to prepare the balance sheet and income statement.

With manual accounting systems, you can only get current financial statements by posting all the journal entries made since the last financial statements, preparing a trial balance and completing the worksheet. Since this is a lot of work (manually) it is usually only done at the end of every month.

With a computerized accounting system based on the system used in the National Construction example, your financial statements are as current as your last journal entry.

Chapter 10

Classified Financial Statements

National Construction continues in business and at the end of its first year in business, its transactions have resulted in a longer balance sheet and a longer income statement.

Each statement has more accounts on it and the accounts are categorized by types. Because of this categorization of accounts they are called **classified statements**. The purpose of classified statements is to group accounts into sets that give similar information.

The Balance Sheet

The balance sheet categories include current and fixed assets, current and long-term liabilities, and equity.

Assets

Assets are all the physical things and other items of value owned by a company. They are listed on the left side of the balance sheet.

Current Assets — Current assets are assets which are converted into cash in the ordinary course of business and in less than one year. They are listed in the order in which the assets may most easily be converted into cash. This category is very important because it is a measure of how quickly the company can pay its

creditors and deal with an unexpected situation that requires lots of cash quickly.

Fixed Assets — Fixed assets are assets such as land, buildings, equipment, and trucks that are used in operating the business and which have a long life. They are generally not converted into cash in the ordinary course of business. This category is important because it is a measure of the amount of physical assets that the company needs to allow it to earn revenue.

Liabilities

Liabilities are all the debts and money owed to others by the company. They are listed on the right side of the balance sheet.

Current Liabilities — The term current liabilities generally refers to liabilities due to be paid within a year or less. If possible, they are listed in the order that they are to be paid. This category is very important because it is a measure of how much money the company owes to others that must be paid relatively soon. If it is more than the amount of current assets, the company may have problems paying creditors quickly and regularly.

Long-Term Liabilities — Long-term liabilities are liabilities that are not due to be paid within the next year after the balance sheet date. A loan payable in two years and a mortgage payable in 25 years are examples. This category is important because when compared to the total amount of equity, it is a measure of how risky further loans to the company might be.

Equity

This category is important because it provides information about how much money was invested in the company and how much money was earned by the company.

National Construction is set up as a proprietorship. Partnerships and corporations have different equity sections than the National Construction example and will be covered later. They still have the same general categories as below, but with different names:

1. Money invested in the company, and
2. Money earned by the company.

National Construction Balance Sheet January 31, 1996			
Assets:		Liabilities:	
Current Assets		Current Liabilities	
Cash in Hand	\$ 100	Accounts Payable	\$ 20,000
Cash in Bank	60,000	Operating Loan	<u>10,000</u>
Accounts Receivable	38,000	Total Current Liabilities	30,000
Maintenance Supplies	1,000	Long Term Liabilities	
Prepaid Insurance	<u>2,000</u>	Mortgage	95,000
Total Current Assets	101,100	Bank Loan	<u>40,000</u>
Fixed Assets		Total Long Term Liabilities	<u>135,000</u>
Land	70,000	Total Liabilities	<u>165,000</u>
Buildings	40,000		
Trucks	32,000	Equity:	
Construction Equipment	20,000	Jim Brown	48,000
Furniture	<u>2,000</u>	Current Earnings	<u>52,100</u>
Total Fixed Assets	<u>164,000</u>	Total Equity	<u>100,100</u>
Total Assets	<u>\$ 265,100</u>	Total Liabilities & Equity	<u>\$ 265,100</u>

The Income Statement

The income statement categories include revenues, expenses, and income.

Revenues

Revenues are categorized by the type of goods or services provided. This categorization is important because the relative sizes of the different types of revenue show where and how a company generates its revenue.

Expenses

Expenses are the amounts that a company spends to provide goods and services to its customers or to carry on its business, except amounts spent to acquire its assets.

Operating Expenses — Operating expenses are expenses that are incurred while providing the goods or services that the company sells. In general, these expenses would no longer be incurred if the company stopped providing the goods or services. It is important to know how much operating expenses are so that a company can see what it costs to provide the goods or services.

Administrative Expenses — These are expenses incurred in the administration of the business, and don't particularly relate to providing particular goods or services. In general, these expenses would still be incurred if the company stopped providing the particular goods or services. It is important to separate these expenses from operating expenses prior to deducting them so that a company can determine whether or not it is making a profit on its operations.

Net Income

This can be called income, profit, or net profit and is the income or loss for the period referred to at the top of the Income Statement. Income, year-to-date means the income from the start of the company's fiscal year to the current date. Fiscal year end is the date that the company selects to use for the end of its

12-month accounting period. National Construction's fiscal year ends January 31.

A company's owners want to know whether or not the company has a reasonable income so that they can decide whether or not to continue operating the company. Creditors also want to be sure that a company has a reasonable income before lending it money.

National Construction Income Statement Feb 1, 1995 - Jan 31, 1996			
Revenues		Expenses	
Hauling	\$ 128,000	Operating	
Excavating	<u>64,000</u>	Wages	\$ 36,000
Total Revenue	<u>192,000</u>	Subcontracts	77,600
		Gas and Oil	8,000
		Maintenance	<u>6,000</u>
		Total Operating	127,600
		Administrative	
		Interest – Mortgage	5,000
		Interest – Bank Loan	2,500
		Interest – Oper. Loan	700
		Professional Fees	1,300
		Telephone	800
		Insurance	1,500
		Utilities	<u>500</u>
		Total Administrative	<u>12,300</u>
		Total Expenses	<u>139,900</u>
		Net Income	\$ <u>52,100</u>

Chapter 11

Adjusting Entries

In this chapter, you will learn how to make adjustments to the financial statements at the end of the year to make the income figures for the year as realistic and accurate as possible.

When and Why

The financial statements shown on the previous pages are correct in that they account for every transaction, but they need to be adjusted for changes related to **accruals**.

The accrual method of accounting says that we should try to match revenues and expenses at the time we record revenues. It also says that we should try to match revenues and expenses (and hence income) to an accounting period. An **accounting period** is the period of time over which income is calculated.

National Construction has an accounting period of one year. This means that we should make adjustments to the financial statements at the end of the year to try and make the income figure as realistic and accurate as possible for that one year. For instance, Brown knows that he owes some interest on his loans, but this has not been recorded yet because he hasn't received a statement from the bank. This interest expense should be recorded at the end of his current year, or the income calculated for the year will be larger than it should be, and smaller the next year when the interest expense is finally taken into account.

If Brown had wanted accurate monthly income figures, he would have had to choose an accounting period of one month and would have had to adjust the financial statements at the end of every month. Most companies actually do choose an accounting period of one month.

The adjusting entries are recorded in the journal in the same way as any other journal entry and the same rules apply.

With a manual accounting system, **adjusting entries** are usually done after the trial balance is prepared and proven to be correct. After the adjusting entries are posted to the ledger accounts, an **adjusted trial balance** is prepared to ensure that no posting or adding mistakes have been made. The financial statements are then prepared.

Prepaid Expenses

Prepaid expenses are assets that have been paid for but which will become expenses over time. Insurance is a good example. An insurance policy is an asset. It is paid for in advance, will last for a period of time, and expires on a fixed date. You buy insurance to cover you for the whole year, so you should allocate its cost evenly over the year.

When National Construction bought one year of truck insurance on August 1, 1995 Brown made this journal entry to record it:

Aug 1, 95	Prepaid Insurance Cash in Bank Truck Insurance expiring 31 July 96	1450 1020	2,000	2,000
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At his year end he must make an adjusting entry to expense the amount of insurance used up between Aug. 1, 1995 and Jan. 31, 1996. Six months of insurance has been used, so the expense is $6/12 \times \$2,000 = \$1,000$. The adjusting entry to record this requires an Insurance Expense account and reduces the balance of the Prepaid Insurance account:

Jan 31, 96	Insurance Expense Prepaid Insurance Adjustment for prepaid insurance	5240 1450	1,000	1,000
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Use of Supplies

Maintenance supplies are used up throughout the year. It is therefore necessary to record their use as an expense. The way to determine the amount of the expense is to physically take an inventory of what is left at the end of the accounting period.

Since the balance of the Maintenance Supplies account tells us how much should be there, we can subtract the ending inventory and determine how much was used.

Brown takes an inventory of National's maintenance supplies on January 31, 1996 and finds that what is left is worth \$300. He then knows that he used up \$700 worth of supplies because the account balance told him that there should have been \$1,000 worth of supplies there. This is because he had debited the account for \$1,000 when he purchased the supplies.

His journal entry to expense the supplies and reduce the Maintenance Supplies account balance to what is really left is:

Jan 31, 96	Truck Maintenance Expense	5080	700	
	Maintenance Supplies	1400		700
	Adjustment for supplies used			

Bad Debts

National's Accounts Receivable of \$38,000 is probably overstated by \$2,000 because a company that owes it \$2,000 is almost bankrupt, and it is very unlikely that National will ever collect the money. Because we don't know for sure that the money will ever be paid, we can reveal this fact on the financial statements, and at the same time adjust the year's income to reflect the probable bad debt.

We set up an account on the balance sheet called Allowance for Doubtful Accounts which is then subtracted from Accounts Receivable on the balance sheet, like this:

Current Assets			
Accounts Receivable	38,000		
Less: Allowance for Doubtful Accounts	<u>2,000</u>		
Net Accounts Receivable			36,000

The Allowance for Doubtful Accounts has a credit balance, which is what we expect since it is subtracted from Accounts Receivable.

Since revenue of \$2,000 was recorded when the contract was completed, income must be reduced by \$2,000 since National may never receive the money owed from the contract. Rather than simply reduce one of the revenue accounts by \$2,000, we create an expense account called Bad Debts since the problem wasn't earning the money, it was collecting it.

The adjusting entry to record this is:

Jan 31, 96	Bad Debt Expense	5120	2,000	
	Allowance for Doubtful Accounts	1210		2,000
	Invoice #1387 likely uncollectable			

Depreciation

Equipment deteriorates during use and therefore loses value each year. Part of the cost of the equipment should be allocated as an expense to each year's operation benefiting from its use. This allocation of the cost of a piece of equipment over its useful life is called **depreciation**.

Brown determines a fair allocation of the cost of his equipment over its useful life and determines these depreciation figures for the year ended January 31, 1996: Trucks – \$8,000; Construction Equipment – \$5,000; and Buildings – \$4,000.

Rather than simply reduce the balance of the Trucks, Construction Equipment and Buildings accounts on the balance sheet, more information is provided if we create accounts called Accumulated Depreciation for each, which have credit balances for the same reasons as the Allowance for Doubtful Accounts account.

On the balance sheet the Trucks account would look like this:

Fixed Assets		
Trucks	32,000	
Less: Accumulated Depreciation	<u>8,000</u>	
Trucks: net		24,000

Here the "net" means net of depreciation.

The journal entries to adjust the statements for the depreciation expense are:

Jan 31, 96	Depreciation Expense	5100	8,000	
	Accumulated Depreciation – Trucks	1610		8,000
	To record '95's depreciation			
Jan 31, 96	Depreciation Expense	5100	5,000	
	Accumulated Depreciation – Eqpt.	1660		5,000
	To record '95's depreciation			
Jan 31, 96	Depreciation Expense	5100	4,000	
	Accumulated Depreciation – Bldgs.	1560		4,000

Accrued Expenses

Some expenses have accrued (been incurred even though National hasn't yet received a bill or invoice from the supplier of the goods or services) by year end. National owes its employees wages of \$1,000 because it is one week before payday, and Brown's banker tells him that by January 31, 1996 National's loans had accumulated unpaid interest as follows: Mortgage – \$600; Bank Loan – \$300 and Operating Loan – \$100.

The adjusting entries to record these unpaid, but accrued, expenses are:

Jan 31, 96	Wage Expense	5020	1,000	
	Wages Payable	2060		1,000
	Adjusting entry for accrued wages			
Jan 31, 96	Interest Expense – Mortgage	5140	600	
	Interest Expense – Bank Loan	5160	300	
	Interest Expense – Operating Loan	5180	100	
	Interest Payable.	2020		1,000
	Adjusting entry for accrued interest			

When these accrued expenses are actually paid (for instance, National pays its \$2,000 payroll on February 7) Brown must consider the amount that he has already expensed in an adjusting entry (\$1,000 wage expense on January 31) to be sure that he doesn't count it twice.

In this case the journal entry to record the actual payment of wages would be:

Feb 7, 96	Wage Expense	5020	1,000	
	Wages Payable	2060	1,000	
	Cash in Bank	1020		2,000
	Wage expense and payment after Jan. 31			

Another option is to reverse the adjusting entry and then enter the wage transaction as if the adjusting entry had never been made. Such an entry (like the first one below) is called a **reversing entry**.

Feb 7, 96	Wages Payable	2060	1,000	
	Wage Expense	5020		1,000
	To reverse adjusting entry of Jan 31			
Feb 7, 96	Wage Expense	5020	2,000	
	Cash in Bank	1020		2,000
	Wages to Feb. 7, 1996			

Accrued Revenues

Some revenues have been earned by year end even though National hasn't invoiced a customer or received payment. A good example is interest accrued on the company's cash in the bank. Brown's banker tells him that National's bank deposits have earned interest of \$600 by January 31, 1996, but that the bank won't pay the interest until the middle of the next month.

The adjusting entry to record this earned, but unpaid, interest is:

Jan 31, 96	Interest Receivable	1100	600	
	Interest Earned on Deposits	4300		600
	Adjusting entry on accrued interest earned			

When, on February 15, National is paid interest of \$700, including the \$600 that has already been recorded as Interest Earned and Interest Receivable, the journal entry is:

Feb 15, 96	Cash in Bank	1020	700	
	Interest Receivable	1100		600
	Interest Earned on Deposits	4030		100
	Interest earned, receivable and paid			

Chapter 12

The Finished Financial Statements

The financial statements will now more accurately reflect the income earned during the accounting period of February 1, 1995 to January 31, 1996 and the true financial position of the company on January 31, 1996. Here are the financial statements updated with the adjusting entries:

National Construction Income Statement Feb 1, 1995 - Jan 31, 1996			
Revenue		Expenses	
Hauling	\$ 128,000	Operating	
Excavating	64,000	Wages	\$ 37,000
Interest	<u>600</u>	Subcontracts	77,600
Total Revenue	<u>192,600</u>	Gas and Oil	8,000
		Maintenance	<u>6,700</u>
		Total Operating	129,300
		Administrative	
		Depreciation	17,000
		Bad Debts	2,000
		Interest – Mortgage	5,600
		Interest – Bank Loan	2,800
		Interest – Oper. Loan	800
		Professional Fees	1,300
		Telephone	800
		Insurance	2,500
		Utilities	<u>500</u>
		Total Administrative	<u>33,300</u>
		Total Expenses	<u>162,600</u>
		Net Income	\$ <u>30,000</u>

**National Construction
Balance Sheet
January 31, 1996**

Assets

Current Assets

Cash in Hand	\$ 100
Cash in Bank	60,000
Interest Receivable	600
Accounts Receivable	\$ 38,000
Less:	
Doubtful Accounts	<u>2,000</u>
Net Receivables	36,000
Maintenance Supplies	300
Prepaid Insurance	<u>1,000</u>
Total Current Assets	98,000

Fixed Assets

Land	70,000
Buildings	40,000
Less:	
Accumulated Dep.	<u>4,000</u>
Buildings: Net	36,000
Trucks	32,000
Less:	
Accumulated Dep.	<u>8,000</u>
Trucks: Net	24,000
Construction Equip.	20,000
Less:	
Accumulated Dep.	<u>5,000</u>
Equipment: Net	15,000
Furniture	<u>2,000</u>
Total Fixed Assets	147,000

Total Assets **\$ 245,000**

Liabilities

Current Liabilities

Interest Payable	\$ 1,000
Wages Payable	1,000
Accounts Payable	20,000
Operating Loan	<u>10,000</u>
Total Current Liabilities	32,000

Long-Term Liabilities

Mortgage	95,000
Bank Loan	<u>40,000</u>
Total Long-Term Liabilities	<u>135,000</u>

Total Liabilities **167,000**

Equity

Jim Brown	48,000
Current Earnings	<u>30,000</u>

Total Equity **78,000**

Total Liabilities & Equity **\$245,000**

Chapter 13

Starting the Next Accounting Period

The financial statements are now complete for the fiscal year ended January 31, 1996 and Brown can now proceed to do the accounting for the next accounting period.

He has two choices for where to post his new accounting data after entering it in the journal: he can continue to use his current ledger; or, he can buy a new ledger and start posting in it.

Closing the Books

If he wants to continue to use the current ledger, he must make the balances of all the revenue and expense accounts zero so that his new accounting period doesn't reflect any of last year's revenues or expenses.

He does this because he is going to do the accounting for a new period, and doesn't want income for this period to reflect any revenues or expenses from the period that has just ended. He leaves the balance sheet accounts unaltered because they pertain to a particular date, not a period of time, the way income does. This process is called **closing the books**.

To close the books, a very simple but lengthy journal entry is made which makes the revenue and expense account balances go to zero, takes what's left over (the year's income) and makes it a new account under equity on the balance sheet called Previous Years' Earnings.

In proprietorships like National Construction, what's left over is generally credited directly to the Owner's Investment account, but it is shown separately here because it gives us more

information. In Corporations, the Previous Years' Earnings account is called Retained Earnings.

The journal entry looks like this, and it debits revenue accounts by the amount of their credit balance and credits expense accounts by the amount of their debit balance:

Jan 31, 96	Hauling Revenue	4100	128,000	
	Excavating Revenue	4200	64,000	
	Interest Earned on Bank Deposits	4300	600	
	Wage Expense	5020		37,000
	Subcontracts Expense	5040		77,600
	Gas and Oil Expense	5060		8,000
	Maintenance Expense	5080		6,700
	Depreciation Expense	5100		17,000
	Bad Debt Expense	5120		2,000
	Interest – Mortgage	5140		5,600
	Interest – Bank Loan	5160		2,800
	Interest – Operating Loan	5180		800
	Professional Fees	5200		1,300
	Telephone	5220		800
	Insurance	5240		2,500
	Utilities	5260		500
	Previous Years' Earnings	3600		30,000
	To close revenue and expense accounts			

After this entry is posted, revenue and expense accounts will have zero balances and the balance sheet will be the same as before the closing entry, except that the balance of what had been called the Current Earnings account has been transferred to an account called Previous Years' Earnings:

Equity	
Jim Brown	48,000
Previous Years' Earnings	<u>30,000</u>
Total Equity	78,000

Opening the Books

If Brown wants to use a new ledger, he can leave the old ledger and all its account balances as they were at January 31, 1996. He must now set up a new ledger so that the asset, liability and equity account balances are the same as those of the old ledger on January 31, 1996. This is called **opening the books**. He doesn't have to open the revenue and expense accounts with their old balances because he wants them to have a zero balance in his new ledger. This ensures that only revenues and expenses for the upcoming accounting period are reflected in the income statement for the upcoming period.

To open the books, a journal entry is made which simply assigns the new ledger accounts the same balances as those in the old ledger, and sets up a new account called Previous Years' Earnings, which is assigned the balance shown beside Current Earnings on the January 31, 1996 balance sheet:

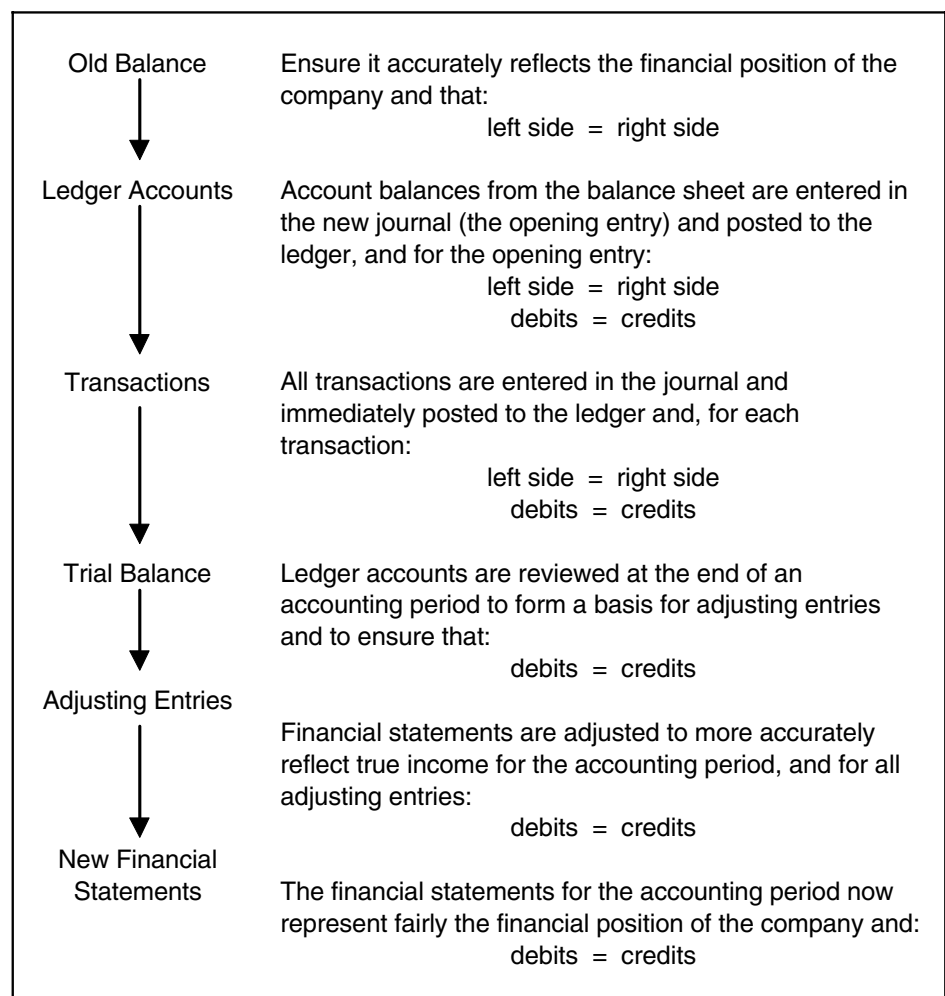
Feb 1, 96	Cash in Hand	1010	100	
	Cash in Bank	1020	60,000	
	Interest Receivable	1100	600	
	Accounts Receivable	1200	38,000	
	Allowance for Doubtful Accounts	1210		2,000
	Maintenance Supplies	1400	300	
	Prepaid Insurance	1450	1,000	
	Land	1500	70,000	
	Buildings	1550	40,000	
	Accumulated Depreciation – Bldgs	1560		4,000
	Trucks	1600	32,000	
	Accumulated Depreciation – Trucks	1610		8,000
	Construction Equipment	1650	20,000	
	Accumulated Depreciation – Eqpt.	1660		5,000
	Furniture	1700	2,000	
	Interest Payable	2020		1,000
	Wages Payable	2060		1,000
	Accounts Payable	2080		20,000
	Operating Loan	2100		10,000
	Mortgage Payable	2400		95,000
	Bank Loan	2500		40,000
	Jim Brown	3300		48,000
	Previous Years' Earnings	3600		30,000
	To open Ledger accounts for '96			

After this entry is posted, revenue and expense accounts still have a zero balance and the balance sheet accounts will have the same balances that they did at January 31, 1996, except that there is a new account called Previous Years' Earnings.

Chapter 14

Summary of Financial Statement Preparation

Chapter 13 concludes the instructions on how to prepare financial statements. The rest of this manual deals with specific situations for companies of different legal forms than a proprietorship, or in different industries. The process of preparing financial statements is summarized below, going from the beginning of an accounting period to the end of an accounting period.



Chapter 15

Other Types of Legal Organizations

There are two other principal forms of companies: partnerships and corporations. The accounting for them is exactly the same as for a proprietorship (National Construction) except that the equity section is set up a little differently for each.

Partnerships

Each partner who invests money in a company has an Invested Capital account in his name. Let's look at an example where we assume that Jim Brown takes on a partner in National Construction.

Brown's equity in the company is \$78,000 (\$48,000 invested plus \$30,000 earned). Because he is about to take on a partner, he adjusts the accounts so that Previous Years' Earnings are now shown as part of his investment.

The journal entry for this is:

Feb 1, 96	Previous Years' Earnings	3600	30,000	
	Jim Brown, Invested Capital	3300		30,000
	To close P.Y.E. into Brown's Capital			

The equity section of the balance sheet now looks like this:

Equity	
Jim Brown	78,000

The same day he takes on a partner who invests \$78,000 cash in the company. The journal entry to record this is:

Feb 1, 96	Cash in Bank	1020	78,000	
	Mike Wood, Invested Capital	3320		78,000
	Partner's initial investment			

The equity section of the balance sheet now looks like this:

Equity	
Jim Brown	78,000
Mike Wood	<u>78,000</u>
Total	156,000

When Brown and Wood became partners, they agreed to equally share the profits earned by National Construction. If we assume that at the end of the year the company has earned \$100,000, and it is recorded in the Current Earnings account.

A journal entry like this would be made to allocate each partner his share of the year's income:

Jan 31, 97	Current Earnings	3620	100,000	
	Jim Brown	3300		50,000
	Mike Wood	3320		50,000
	To allocate income to partners			

The equity section of the balance sheet now looks like this:

Equity	
Jim Brown	128,000
Mike Wood	<u>128,000</u>
Total	256,000

Corporations

A corporation (also called a limited company), unlike a proprietorship or partnership, is a business that has a legal existence of its own. It is legally separate from its owners. It has the right to sue and be sued by others. The owners have limited liability in that they can only lose what they invested in the corporation. They cannot be sued for the debts of the corporation, except as provided in law.

The Equity section of sole proprietorships and partnerships is known as Shareholders' Equity for corporations.

The equity of a corporation belongs to the shareholders. Shareholders are persons who bought shares (stock) of the company, which are certificates that indicate ownership of a part of a company. There are two types of shares usually issued by a corporation to its owners:

Preferred Shares — Preferred shares may pay to its owners a dividend (a payment made to shareholders by a corporation out of after-tax earnings) that is usually fixed in amount or percent. Preferred shareholders have preference. If there are any dividends declared, the preferred shareholders get their dividends before the common shareholders are entitled to any dividends.

Common Shares — Common shares have no preference to dividends and no fixed rate of return. It is the most common kind of share and normally has voting rights attached to it. Since common shares are usually the only type of shares with voting rights, the shareholders who control the common shares also control the company. Since a corporation is a separate legal entity from its owners, it must keep its own accounting records.

The equity section of the balance sheet shows each type of share issued (subscribed for), and how much money was received for it by the company. It does not show who owns the shares or how much they own because this is something that the company does not control. Shareholders are generally free to sell their shares to each other or others who are currently not shareholders.

If National Construction was organized as National Construction Limited, and Jim Brown and Mike Wood each bought 5,000 common shares for \$20 per share and 14,000 preferred shares for \$2 per share, the equity (sometimes called Stockholders' Equity or Shareholders' Equity for a corporation) section of the balance sheet would look like this:

Equity	
Paid in Capital	
Common Shares	200,000
Preferred Shares	<u>56,000</u>
Total Paid in Capital	256,000

When balance sheets are more formally prepared, it is standard practice to show beside each type of share how many shares were authorized and how many are issued and outstanding.

The journal entry in the corporation's journal to record the issuance of the above shares is:

Feb 1, 96	Cash in Bank	1020	256,000	
	Common Shares	3800		200,000
	Preferred Shares	3850		56,000
	Issued 10,000 common @ \$20; and 28,000 preferred @ \$2			

At the end of the year, National Construction Limited, like National Construction the proprietorship, would transfer the balance of the Current Earnings account to the Previous Years' Earnings account. For corporations, this is called the Retained Earnings account, because the earnings have been retained by the company rather than paid out to the shareholders as dividends.

Even though the corporation has an account called Retained Earnings, it may not be able to pay this amount out to its shareholders quickly because it may not have that much cash in the bank. It may have to convert some assets into cash (by selling them, or if they are receivables, collecting them) before it can distribute the retained earnings to its shareholders.

Let's assume that National Construction Limited has \$100,000 of retained earnings and pays a dividend of \$1 per share to its preferred shareholders' (28,000) shares on Jan. 31, 1997. The journal entry to record this is:

Jan 30, 97	Retained Earnings	3900	28,000	
	Cash in Bank	1020		28,000
	Paid \$1 dividend on 28,000 preferred shares			

The Shareholders' Equity section of the balance sheet adjusted for the above transaction is:

Equity	
Paid in Capital	
Common Share	200,000
Preferred Shares	<u>56,000</u>
Total Paid in Capital	256,000
Retained Earnings	<u>72,000</u>
Total Equity	328,000

Accounting for the shares of corporations can get extremely detailed and involved. If transactions other than the types explained above are contemplated or have actually been done, a reference book that covers share transactions more thoroughly should be consulted.

Chapter 16

Subsidiary Ledgers

This chapter tells you how to use subsidiary ledgers to keep information that will help you make decisions about your company.

Why and How

Subsidiary ledgers are a system in which a particular ledger account (such as Accounts Receivable) has its own ledger called a **subsidiary ledger**. There is generally an account in the subsidiary ledger for each customer (or supplier or employee).

The purpose of subsidiary ledgers is to keep the main ledger uncluttered of details and provide management with useful and necessary information. A company should start to use subsidiary ledgers when it finds its general ledger is getting too cluttered, or that its financial records don't contain enough information for the management to make decisions.

When an entry is made in the subsidiary ledger to record, say, one particular customer paying a bill, the main ledger only has a debit to Cash and a credit to Accounts Receivable, while the subsidiary ledger contains all the details (when the customer paid, how he or she paid, how much is still outstanding, etc.).

Depending on the type of subsidiary ledger, the summary of the transactions in the subsidiary ledger need only be transferred to the main ledger periodically. This is always done before income for a period is determined and may be done more often if desired.

Accounts Receivable

This subsidiary ledger keeps track of who your customers are, what their addresses are, and how much money they owe you. It also breaks down the money they owe you by current receivables, overdue 30 - 60 days and any other period that you might decide to follow. It keeps track of the date you invoiced a particular customer, when the customer paid, and how much was paid. If all the data is entered into the ledger, it is an easy-to-use and accurate system for determining whom you might extend more credit to and whom you need to concentrate your collection efforts on.

Following is an example of how particular customer records might be kept in an Accounts Receivable subsidiary ledger:

Customer	Current	31-60	61-90	91+	Total
Western Wholesaling Corp. 1143 Boardwalk Avenue Seattle, WA	\$500	\$50	—	—	\$550
Johnson Enterprises Ltd. 2532 Park Place Vancouver, BC	—	—	\$700	—	\$700

The company's management can now very clearly see that they should not extend more credit to Johnson Enterprises Ltd. until they improve their payment record.

Accounts Payable

This subsidiary ledger accomplishes many of the same things as the Accounts Receivable subsidiary ledger and provides a record of who is owed money and for how long. This allows a company to maintain a good credit rating by not overlooking bills that must be paid.

Payroll

This subsidiary ledger allows management to keep track of employee wages and all the deductions that must be collected and paid out, as well as the employer's associated expenses. In addition it keeps track of names, addresses, social security numbers, rates of pay, and normal hours per pay period. It also summarizes the deductions for each employee, the employer's associated expenses, and to whom the amounts are owed.

Inventory

This subsidiary ledger allows management to keep track of what is in stock and how much it costs. The ledger must be updated frequently in order to keep accurate information as to how much inventory has been sold or is in stock. It keeps track of supplier names, their addresses, stock numbers, quantities normally ordered, price discounts available and of course the amount and value of stock in inventory right now.

Chapter 17

Open Invoice Accounting for Payables and Receivables

This chapter describes a method of accounting known as the **open invoice** method.

Instead of merely keeping track of the outstanding balance of each vendor and customer, open invoice accounting keeps track of each individual invoice, together with each partial payment made against it. When fully paid, it becomes optional whether the invoice and its payments are retained or purged.

Late Payment Charges

The open invoice method provides sufficient detail to allow calculations of interest charges on overdue receivables. Similarly you may have to pay interest charges on your overdue payables.

Consider the interest charge as an invoice which should subsequently be paid along with other invoices. When you enter these late payment invoices the matching entry would either be to Interest Expense (in the case of accounts payable) or to Interest Revenue (in the case of accounts receivable).

Discounts

The open invoice method provides sufficient detail to allow you to take advantage of discounts offered by suppliers for early payment of their invoices. These discounts can be considered as negative invoices from your suppliers to reduce the amount of prior invoices. You can consider negative invoices either to be a

revenue (for example: Discounts Taken Revenue) or as a reduction in the expense associated with the original invoice.

Similarly, if you offer a discount for early payment to your customers, you may receive less than your original invoices to your customers. These discounts can be considered as negative invoices to reduce the amount of prior invoices. You can consider negative invoices either to be an expense (for example: Discounts Taken Expense) or as a reduction to the revenue associated with the original invoice.

Bad Debts

An invoice in receivables which is not collectable may have to be written off as a bad debt. When you decide that an invoice is uncollectable, you can process it in one of two ways.

You could consider the invoice to be fully paid. This would serve the purpose of removing the invoice as an open invoice. However, it would also debit the cash account. If you use this method to remove the invoice as an open invoice, you would have to make a second entry in the general journal to credit cash and debit a Bad Debt Expense account.

Alternatively, to record the invoice as a bad debt an entry could be made in the subsidiary journal to debit the bad debts expense and credit the accounts receivable control account.

		Debit	Credit
5500	Bad Debts Expense	620	
1200	Accounts Receivable		620

Prepayments

You or a customer may be required to make a prepayment for goods or services that will be received in the future. Record the prepayment from a customer in the Accounts Receivable Sales journal. Use the customer's check number for an invoice number. Debit the Cash in Bank account and credit Accounts Receivable.

If you subsequently refund the prepayment, record it as a negative invoice in the Accounts Receivable journal. Enter the number of your refund check as an invoice number. Credit the Cash in Bank account and debit the Accounts Receivable account.

Record a prepayment to a vendor in the Accounts Payable journal. When you enter the prepayment, use your check number for an invoice number. Credit the Cash in Bank account, and debit the Accounts Payable account.

If your prepayment is subsequently refunded, record the transaction in the Accounts Payable journal. Debit the Cash in Bank account and credit the Accounts Payable.

Chapter 18

Payroll Accounting

This chapter describes how to prepare your company's payroll in accordance with the requirements of the federal and state governments and other local authorities having jurisdiction.

Read documentation from IRS and your state's taxation department

While this chapter shows you how to prepare your payroll, it is essential that you read it in conjunction with the documentation supplied by the Internal Revenue Service and your state's taxation department.

This chapter will not, for instance, tell you which benefits are and are not taxable, how to fill in government forms, and when to remit funds to the government. It does show you the procedures for determining the amounts that will go on the government forms, and the procedures for determining the amounts of money your company owes the federal and state governments.

You should obtain *Circular E, Employer's Tax Guide* from the Internal Revenue Service, and your state's tax guide. These will make you aware of situations that involve the interpretation of federal and state regulations by employers.

After reading this chapter and the applicable sections of the tax guides, you should be able to categorize different types of compensation and benefits correctly, and be able to prepare the payroll for your company with confidence.

The preparation of your company's payroll includes the following:

- Determining each employee's gross earnings for a pay period;
- Determining each employee's deductions;
- Calculating the employer's associated expenses;
- Updating the employee payroll records;

- Creating the journal entries; and
- Remitting funds to the relevant governmental authority or other applicable agencies.

At the federal level and most state levels, overtime pay, tips, commissions, benefits, and vacation pay may be considered as supplemental wage payments. There are a variety of ways to calculate taxes and expenses when an employee's paycheck includes a supplemental wage payment.

Circular E, Employer's Tax Guide describes the federal rules to follow; however, even though most states follow the federal rules to calculate an employee's taxable income, you should check your state's tax guide for specific details.

The Internal Revenue Service specified method, used in the examples which follow, is to add together all components of gross earnings for the pay period and calculate taxes and expenses on the aggregate.

The amount of an employee's paycheck for a particular pay period is the employee's gross earnings for the pay period, less any amounts deducted by the employer. The amounts deducted by the employer are paid by the employer to the relevant government authority or other applicable agency.

The difficult part of preparing the payroll is determining the statutory deductions to be withheld from each employee's paycheck and paid to the relevant governmental authority. Deductions that are payable to other agencies are simpler to calculate, but they must also be accounted for on an employee-by-employee basis.

Employers must keep two types of payroll records: their own and their employees'. Employers, of course, need to know what their expenses and payables are as a result of paying their employees. Therefore, the employer keeps records so that the company's financial statements correctly account for the amounts paid, and to be paid, to the employees.

In addition, since it is the employer who deducts money from employee paychecks, it is again the employer who must keep fully detailed records of each amount deducted from each employee's paycheck.

Employers need this information in order to fill in the **941** (Employer's Quarterly Federal Tax Return) form, to determine their **FUTA** (Federal Unemployment Tax Act) payment frequency, to fill in the **W-2** (Wage and Tax Statement) and the **940** (Employer's Annual Federal Unemployment Tax Return) forms at the end of the year, and to be able to answer any questions the employees may have regarding the composition of their paychecks.

Both the employer's and the employees' records should be updated each time a set of payroll transactions has been completed.

Determining an Employee's Gross Earnings

An employee's gross earnings for a pay period are the total amount of compensation that the employee receives during that pay period, a pay period being the period of time between an employee's paychecks. The most common federal and state pay periods per year are 12, 24, 26, and 52.

The most common components of gross earnings include:

Regular Pay	
Overtime Pay	
Salary	
Tips	
Commissions	
Taxable Benefits	
Vacation Pay	
Gross Earnings	_____

An advance to an employee need not be included in gross earnings, providing the advance is covered by later-earned

remuneration or the employee is otherwise made legally obligated to repay the advance. Under these circumstances, an advance can be treated as a loan and need not be included as a component of gross.

The following sections describe how each of these components of gross earnings is determined, together with examples for each.

Regular Pay

Regular pay for hourly paid employees is determined by multiplying the employee's hourly rate of pay by the number of regular hours worked by the employee during the pay period. The employee's regular hourly rate of pay is available from the employee record.

Example: If an employee worked 40 regular hours at \$10 per hour during a two-week period, the employee's regular pay would be \$400.

When a paycheck is produced, you must record this amount as an increase in the Wage Expense account, and make an entry in the employee's record that the employee received this amount as regular pay.

Overtime Pay

Overtime pay for hourly paid employees is determined by multiplying the employee's overtime rate of pay by the number of overtime hours worked during the pay period. The employee's overtime rate of pay is available from the employee record.

Example: If an employee worked 9.5 overtime hours at \$20 per hour during the pay period, the overtime pay would be \$190.

When a paycheck is produced, you must record this amount as an increase in the Wage Expense account, and make an entry in the employee's record that the employee received this amount as overtime pay.

Salary

Salary is a fixed amount paid to the employee for the pay period in question. The employee's regular salary is available from the employee record.

Example: If an employee was paid a salary of \$500 during the pay period in addition to regular and overtime pay, this amount should be entered as the salary component of gross earnings for the pay period.

When a paycheck is produced, you must record this amount as an increase in the Wage Expense account, and make an entry in the employee's record that the employee received this amount as salary.

Tips

Tips are a performance-related amount paid to the employee by third parties (customers) during the pay period in question.

The Internal Revenue Service states that tips under \$20 per month are not considered to be taxable wages, and do not need to be reported.

However, when the tip income is \$20 or more per month, employees must track their tip income and report the amount on a monthly basis to their employers. Employees who share in a "tip pool" must also follow this rule by reporting the tips they actually receive from the distribution of the pooled funds. *Circular E, Employer's Tax Guide* explains further, how and when the employee tracks and reports tips.

When the employee reports tips in excess of \$20 for one month, the entire amount of the reported tip income is taxable — not just the amount over \$20.

Example: If an employee received tips amounting to \$25 during the pay period, this amount should be entered as the tips component of gross earnings for the pay period.

When a paycheck is produced, you must show that the employee received this amount as tips, and the employee's record must be updated to reflect the reported tip income.

The amount of the tips is not recorded as an increase in the Wage Expense account because the value of the tips was not an expense incurred by the employer. However, the \$25 must be entered as a component of gross earnings so that the appropriate deductions can be determined.

Commission

Commission is a performance-related amount paid by the employer to the employee for the pay period in question.

Example: If an employee was paid a commission of \$50 during the pay period, this amount should be entered as the commission component of gross earnings for the pay period.

When a paycheck is produced, you must record this amount as an increase in the Wage Expense account, and make an entry in the employee's record that the employee received this amount as commission.

Taxable Benefits

Any non-cash taxable benefits received by an employee in each or any pay period, must be entered as a component of the employee's gross earnings for the period.

Example: If an employee received free transportation which provided a taxable benefit of \$90 per pay period, this amount should be entered as the taxable benefit component of gross earnings for the pay period.

When the paycheck is produced, it must show that the employee received this amount as a taxable benefit, and the employee's record must be updated to reflect this non-cash benefit.

The amount of this taxable benefit is not recorded as an increase in the Wage Expense account because the transportation expenses have been incurred and accounted for separately. However, the taxable-benefits information must be entered as a component of gross earnings so that the appropriate deductions can be determined.

If the taxable benefit was actually a payment of cash paid to the employee at some prior time, the amount must be entered as a taxable benefit in order to have the source deductions properly calculated.

Vacation Pay

Vacation pay is normally recorded at the time employees take their vacation. It is then recorded as part of the employee's gross wages.

Example: Assume an employee took vacation during a pay period, and was paid \$75 for this.

You must record this amount as an increase in the Wage Expense account and make an entry in the employee's record that the employee received this amount as vacation pay. You must keep accurate records in the individual personnel files of vacation time earned and taken.

The employee's gross earnings for the period would be:

Regular Pay	\$	400.00
Overtime Pay		190.00
Salary		500.00
Tips		25.00
Commissions		50.00
Taxable Benefits		90.00
Vacation Pay		<u>75.00</u>
Gross earnings	\$	1,330.00

Determining an Employee's Deductions

After calculating gross earnings for the pay period you must determine the various amounts to be deducted from the employee's paycheck.

The most common employee deductions are:

FIT (Federal Income Tax)	
SIT (State Income Tax)	
Social Security Tax	
Medicare Tax	
SUTA (State Unemployment Tax Act)	
SDI (State Disability Insurance)	
Local (City/County or other regional income tax)	
Union (or other user-defined after-tax deduction)	
Medical (or other user-defined after-tax deduction)	
Dental (or other user-defined after-tax deduction)	
Total Deductions	_____

The first seven of these deductions are covered by federal, state, or local statutory regulations, and must be deducted by employers, while the last three deductions are usually administered by employers on behalf of their employees.

Here is how the amounts applicable to the above deductions are determined.

FIT (Federal Income Tax)

Employers are required to deduct FIT from an employee's paycheck each pay period and record this amount as a liability in the FIT Payable account.

The FIT to be deducted from each employee's paycheck varies according to:

- The employee's gross earnings,
- The number of pay periods per year,
- The employee's marital status,
- The number of Federal Withholding Allowances claimed.

Each employee must submit to the employer a **W-4** (Employee's Withholding Allowance Certificate) form which specifies the employee's marital status and the number of **Federal Withholding Allowances** being claimed.

This form must be filed when the employee commences employment with a new employer or when a change in personal circumstances occurs which affects the number of allowances claimed.

If an employee has estimated gross annual earnings subject to FIT which are less than or equal to the minimum amount, no FIT should be deducted.

The FIT deduction is based on the gross earnings subject to tax. Using the case from the earlier example and assuming the employee is single, claiming two federal withholding allowances, and has 26 pay periods per year, the amount of gross earnings subject to FIT is calculated as follows.

Gross Earnings	\$ 1,330.00
Less: Pay period value of allowances:	
2 allowances @ \$2,650.00 (1997)	
= $2 \times \$2,650.00 = \$5,300.00$	
At 26 pay periods per year	
= $\$5,300.00 \div 26 \text{ per pay period}$	<u>203.85-</u>
Gross Earnings subject to FIT	\$ 1,126.15

From the 1997 FIT tax tables, assuming the example employee is single and claims two federal withholding allowances, it can be determined that the employer must deduct \$169.28 from the employee's paycheck as FIT for the pay period.

When a paycheck is produced, the employer must deduct this amount from the employee's paycheck, add it to the balance of the FIT Payable account, and make an entry in the employee's payroll record that this amount has been deducted from the paycheck.

SIT (State Income Tax)

Most states require SIT to be deducted from an employee's paycheck each pay period, and use formulas similar to the federal tax deduction formulas, while other states have devised their own unique deduction method. Most of the states require employees to submit to their employer a form giving the particulars of their claims for SIT deductions. Some states use the federal form, while other states require that the employee submit a unique state form in addition to the W-4 already submitted for federal deduction purposes. Because of their unique SIT deduction formulas, some states do not require the submission of a form.

The SIT to be deducted from an employee's paycheck always depends on the state of taxation, the gross earnings, and the number of pay periods per year; however, depending on the state, some of the following components may also be used in calculating SIT to be deducted:

- FIT deducted,
- The employee's marital status,
- The number of federal withholding allowances claimed,
- The number of state withholding allowances claimed,
- The number of additional withholding allowances claimed,
- The number of dependents.

Several states require SIT to be deducted based on any amount of gross earnings. However, most states specify a minimum amount of gross earnings before SIT is to be deducted. If an employee's gross earnings fall below a state's specified minimum for SIT deductions, then no SIT will be deducted at all. You should check your state's tax guide for particulars about your state.

Assume, for example, that an employee is single, employed in New Jersey, claims one state withholding allowance for New Jersey, and is paid every two weeks. It can be determined from New Jersey's 1997 SIT tax tables that the employer must deduct \$21.98 from the employee's paycheck as SIT for the pay period.

When a paycheck is produced, the employer must deduct this amount from the employee's paycheck, add it to the balance of the SIT Payable account, and make an entry in the employee's payroll record that this amount has been deducted from the paycheck.

Social Security Tax and Medicare Tax

The Social Security Tax and Medicare Tax portions of FICA have their own wage bases. Forms 941 and W-2 require

employers to report the withholding and wages separately for each portion.

The examples in this section use the 1997 rates and amounts. The Social Security Tax rate is 6.2 percent with a \$65,400 wage base, and the Medicare Tax rate is 1.45 percent, with no limit.

You deduct both Social Security Tax and Medicare Tax from an employee's check (a total of 7.65 percent of gross earnings) for the *first* \$65,400 in accumulated gross annual earnings. For the portion of the accumulated gross annual earnings *over* \$65,400, you deduct only the 1.45 percent amount for Medicare Tax (with no upper limit on the earnings).

Assume that an employee, with gross earnings of \$1,330 in this pay period, has not earned more than \$65,400 this year. The employer must deduct \$82.46 ($6.2\% \times \$1,330$) from the employee's paycheck as the Social Security Tax contribution, and \$19.29 ($1.45\% \times \$1,330$) as the Medicare Tax contribution.

When a paycheck is produced, the employer must deduct these amounts from the employee's paycheck, add them to the balance of the appropriate tax payable account(s), and make an entry in the employee's record that these amounts have been deducted from the paycheck.

Note that rates and amounts in these examples may change. Check with the federal government authorities for current rates.

SUTA (State Unemployment Tax Act)

In a few states, employers are required to deduct SUTA from an employee's paycheck each pay period and to remit the amount to the state regulatory body. In the enforcing states, you must deduct SUTA from an employee's paycheck by applying a SUTA percentage rate to the employee's gross earnings. Your state will specify the employees' SUTA percentage rate and the maximum gross annual earnings to which you may apply this rate. Each of the participating states uses similar SUTA deduction formulas, which usually vary, depending on:

- Gross earnings,
- The state of taxation,
- Whether the employee has reached the maximum deduction per year for the particular state.

You need to monitor your employees' payroll record of SUTA deductions (if applicable) so that when their gross earnings exceed your state's maximum, you stop deducting an amount for SUTA from their paychecks.

Gross Earnings	\$ 1,330.00
SUTA deduction ($0.525\% \times \$1,330.00$)	6.98
Maximum SUTA deduction ($0.525\% \times \$18,600.00$)	\$ 97.65

Based on the example employee, and assuming that the New Jersey employee's SUTA rate is 0.525%, applicable to maximum gross annual earnings of \$18,600 (basis 1997), the employer must deduct \$6.98 from the employee's paycheck as a SUTA deduction and pay this amount to the state's regulatory body.

When the paycheck is produced, the employer must deduct this amount from the employee's paycheck, add it to the balance of the SUTA Payable account, and make an entry in the employee's record that this amount has been deducted from the paycheck.

SDI (State Disability Insurance)

Depending on the state, SDI may be collected in one of three ways:

- The state bills the employer directly (the employee does not contribute).
- The state bills the employer directly, and requires the employee to make a contribution as well.
- The state bills the employer directly, and the employer has the option to collect a portion of this amount from the employee.

For those states where the employer must recover the payment (or partial payment) from the employee, you must deduct SDI from an employee's paycheck by applying an SDI percentage rate to the employee's gross earnings. Your state will specify the employees' SDI percentage rate and the maximum gross annual earnings to which you may apply this rate.

Each of the participating states uses similar SDI formulas, which usually vary, depending on:

- Gross earnings,
- The state of taxation,
- Whether the employee has reached the maximum deduction per year for the particular state.

You need to monitor your employees' payroll record of SDI deductions (if applicable) so that when their gross earnings exceed your state's maximum, you stop deducting an amount for SDI on their paychecks.

Gross Earnings	\$ 1,330.00
SDI deduction ($0.5\% \times \$1,330.00$)	6.65
Maximum SDI deduction ($0.5\% \times \$18,600.00$)	\$ 93.00

Based on the example employee (again in 1997), and assuming that the New Jersey employee's SDI rate is 0.5% applicable to maximum gross annual earnings of \$18,600, the employer must deduct \$6.65 from the employee's paycheck as the SDI deduction and pay this amount to the state's regulatory body.

When a paycheck is produced, the employer must deduct this amount from the employee's paycheck, add it to the balance of the SDI Payable account, and make an entry in the employee's payroll record that this amount has been deducted from the paycheck.

Local

In many cities, counties, or other jurisdictions, employers are required to deduct local income tax from an employee's paycheck each pay period and to remit the amount to the local government having jurisdiction.

Your local taxing government will specify the formula you need to use in order to calculate the tax deduction. These formulas vary according to the local government but most often involve applying a specified local income tax percentage rate either to the employee's gross earnings, or, to the amount of FIT or SIT deducted for the pay period.

Based on the example employee, and assuming the local income tax formula is specified as 1% of the employee's gross earnings for the pay period, the employer must deduct \$13.30 ($1\% \times \$1,330$) from the employee's paycheck as the local income tax contribution and pay this amount to the local government having jurisdiction.

When a paycheck is produced, the employer must deduct this amount from the employee's paycheck, add it to the balance of the Local Payable account, and make an entry in the employee's payroll record that this amount has been deducted from the paycheck.

Union

Assume that the example employee is covered by a collective agreement that requires the employer to deduct and pay to a union \$12 from the employee's paycheck each pay period.

When a paycheck is produced, the employer must deduct this amount from the employee's paycheck, add it to the balance of the Union Payable account, and make an entry in the employee's payroll record that this amount has been deducted from the paycheck. The employer is then responsible for paying the \$12 to the union having jurisdiction.

Medical

Assume that the employee pays \$15 per pay period into a company-administered medical plan.

When a paycheck is produced, the employer must deduct this amount from the employee's paycheck, add it to the balance of the Medical Payable account, and make an entry in the employee's payroll record that this amount has been deducted from the paycheck. The employer is then responsible for paying the \$15 to the company providing the medical plan.

Dental

Assume that the employee pays \$10 per pay period into a company-administered dental plan.

When a paycheck is produced, the employer must deduct this amount from the employee's paycheck, add it to the balance of the Dental Payable account, and make an entry in the employee's payroll record that this amount has been deducted from the paycheck. The employer is then responsible for paying the \$10 to the company providing the dental plan.

The employee's total deductions for the pay period are therefore:

FIT	\$	169.28
SIT		21.98
Social Security Tax		82.46
Medicare Tax		19.29
SUTA		6.98
SDI		6.65
Local		13.30
Union Dues		12.00
Medical		15.00
Dental		<u>10.00</u>
Total Deductions	\$	356.94

Assuming that the employee requests an advance of \$100 on the next paycheck, the amount of that paycheck can now be calculated as follows:

Gross Earnings	\$	1,330.00
Less: Total Deductions		356.94-
Taxable Benefit		90.00-
Tips		25.00-
Add Advance		<u>100.00</u>
Net to Employee	\$	958.06

The taxable benefits and the tips are deducted after the tax calculations because the employee has already received payment in kind or payment respectively.

Calculating the Employer's Associated Expenses

In addition to the gross earnings expense (less any taxable benefits or tips), the employer must pay the following additional wage-associated expenses:

Social Security Tax Expense	
Medicare Tax Expense	
FUTA (Federal Unemployment Tax Act) Expense	
SUTA (State Unemployment Tax Act) Expense	
SDI (State Disability Insurance) Expense	
Total Employer's Associated Expense	<u> </u>

The above wage expenses are statutory expenses and must be paid by all employers (though not all states have SDI).

Social Security and Medicare Tax Expense

The Internal Revenue Service requires employers to make Social Security and Medicare contributions, in addition to withholding the correct amounts from their employees. In 1997, the

employer must pay an amount equal to each employee's Social Security Tax and Medicare Tax deduction.

If the example employee's gross earnings are \$1,330 for this pay period (and the employee has not earned more than \$65,400 this year), the employer must record \$82.46 ($6.2\% \times \$1,330$) as the Social Security Tax contribution, and \$19.29 ($1.45\% \times \$1,330$) as the Medicare Tax contribution.

The employer's total expense is therefore \$101.75, and the amount payable to the Internal Revenue Service is \$203.50.

Each time a paycheck is produced, you must calculate and make the necessary journal entries to record the employer's portion of the Social Security and Medicare contributions. Journal entries would increase the appropriate tax expense account(s) and the appropriate tax payable account(s).

Note that rates and amounts in these examples may change. Check with the federal government authorities for current rates.

FUTA (Federal Unemployment Tax Act) Expense

All employers are required to make contributions to the Federal Unemployment Tax plan. The employer's FUTA liability usually varies, depending on:

- The employer's FUTA percentage rate,
- The employees' gross earnings,
- The number of employee pay periods per year,
- The employees' maximum taxable earnings to which the FUTA percentage rate is applied (in 1997 this was \$7,000.)

You need to monitor your record of FUTA contributions according to each employee's gross earnings, so that when an employee's earnings exceed \$7,000, you no longer contribute an amount for FUTA.

Based on the example employee, and assuming that this employer's FUTA percentage rate is 0.8% applicable to an employee's maximum gross annual earnings of \$7,000 (and the employee's gross earnings for the year do not exceed \$7,000), the employer must record a \$10.64 ($0.8\% \times \$1,330$) FUTA contribution.

When a paycheck is produced, the employer must increase the FUTA Expense and the FUTA Payable accounts by the calculated amount. There is no entry in the employee's record because nothing has been deducted from the employee's paycheck.

SUTA (State Unemployment Tax Act) Expense

All states require employers to contribute to the state's SUTA plan. Although each of the state's SUTA formulas are similar to each other, they usually vary, depending on:

- The employer's SUTA percentage rate,
- The employees' gross earnings,
- The number of employee pay periods per year,
- The employees' maximum taxable earnings to which the SUTA percentage rate is applied (this varies by state).

Employers are assigned a SUTA percentage rate by the state's tax department. These rates can vary from employer to employer.

You need to monitor your record of SUTA contributions according to each employee's gross earnings, so that when an employee's gross earnings exceed your state's maximum, you no longer contribute an amount for SUTA.

Based on the example employee, and assuming that this New Jersey employer's 1997 SUTA percentage rate is 0.75% applicable to the employee's maximum gross annual earnings of \$18,600 (and that the employee's gross earnings for the year do

not exceed \$18,600), the employer must record \$9.98 ($0.75\% \times \$1,330$) as the SUTA contribution for this employee.

When a paycheck is produced, you must increase the SUTA Expense and the SUTA Payable accounts by the calculated amount.

SDI (State Disability Insurance) Expense

A few states require employers to contribute to the state's SDI fund. The formulas usually vary, depending on:

- The employer's SDI percentage rate,
- The employees' gross earnings,
- The number of employee pay periods per year,
- The employees' maximum taxable earnings to which the SDI percentage rate is applied (this varies by state).

Employers are assigned an SDI percentage rate by the state's tax department.

You need to monitor your record of SDI contributions according to each employee's gross earnings, so that when an employee's gross earnings exceed your state's maximum, you no longer contribute an amount for SDI.

Based on the example employee, and assuming that this New Jersey employer's 1997 SDI percentage rate is 0.75% applicable to an employee's maximum gross annual earnings of \$18,600 (and the employee's gross earnings for the year do not exceed \$18,600), the employer must record a \$9.98 ($0.75\% \times \$1,330$) SDI contribution.

When a paycheck is produced, you must increase the SDI Expense and the SDI Payable accounts by the calculated amount.

Updating the Employee's Payroll Record

An employer must keep records of the amounts each employee was paid, and the amounts deducted from their paychecks, to ensure the employer's accurate completion of the federal W-2 Wage and Tax statements for the Internal Revenue Service, and a similar state form if required, at the end of the calendar year.

Each employee's payroll record should be updated each time a paycheck is produced for that employee. Aside from tracking quarter-to-date and year-to-date totals of every category of gross earnings, deductions, and associated employer payroll expenses, the employee's record tracks:

- Vacation Paid
- Payroll Advances
- FIT Taxable Earnings
- SIT Taxable Earnings
- Social Security Taxable Earnings (employee's and employer's)
- Medicare Taxable Earnings (employee's and employer's)
- Social Security Taxable tips (employee's and employer's)
- Medicare Taxable tips (employee's and employer's)
- FUTA Taxable Earnings
- SUTA Taxable Earnings (employee's and employer's)
- SDI Taxable Earnings (employee's and employer's)

The Vacation Paid amount is the total of all vacation time which has been paid out. For instance, if an employee had taken seven hours of vacation at an hourly rate of \$10 per hour, Vacation Paid would total \$70.

The Payroll Advances amount is the total of all advances that have been given to the employee, but have not yet been recovered. For instance, if an employee received an advance of \$300, and the employer subsequently recovered \$200 of the advance, the Payroll Advances would be \$100.

The FIT Taxable Earnings, SIT Taxable Earnings, Social Security Taxable Earnings, and Medicare Taxable Earnings are amounts that must be entered on an employee's W-2 form at the end of each calendar year. As a result, the amounts calculated and recorded by the employer must be the totals for the calendar year-to-date.

The FIT Taxable Earnings, Social Security Taxable Earnings, and Medicare Taxable Earnings, in addition to Social Security Taxable Tips and Medicare Taxable Tips, are amounts that must also be entered on the 941, Employer's Quarterly Federal Tax Return. The amounts calculated and recorded by the employer for this purpose must be the totals for the calendar quarter-to-date. The employer, then, must track both quarter-to-date and year-to-date information on FIT, SIT, Social Security Taxable Earnings, and Medicare Taxable Earnings.

The FUTA Taxable Earnings is information required for use with the 940, Employer's Annual Federal Unemployment Tax Return. You need to know quarter-to-date information to determine your required FUTA payment frequency. You need to know year-to-date information to fill out the 940 report at the end of the year. The employer must keep a record of FUTA Taxable Earnings information for the quarter-to-date and year-to-date.

SUTA Taxable Earnings, and in some cases the SDI Taxable Earnings, are entered on the state reporting forms each quarter. The amounts calculated and recorded by the employer must be for the calendar quarter-to-date.

Creating the Journal Entries

The employer must make all the necessary journal entries to account for each paycheck produced. The journal entry to account for the paycheck prepared as an example is as follows:

Universal Construction Journal				
Date	Particulars	#	Debit	Credit
Jul 26, 97	Wage Expense	5300	1,215.00	
	Social Security/Medicare Expense	5310	101.75	
	FUTA Expense	5320	10.64	
	SUTA Expense	5330	9.98	
	SDI Expense	5340	9.98	
	Advances Receivable	1240	100.00	
	FIT Payable	2320		169.28
	SIT Payable	2330		21.98
	Social Security/Medicare Payable	2340		203.50
	FUTA Payable	2350		10.64
	SUTA Payable	2360		16.96
	SDI Payable	2370		16.63
	Local Payable	2380		13.30
	Union Payable	2390		12.00
	Medical Payable	2400		15.00
	Dental Payable	2410		10.00
	Cash in Bank	1100		905.44

Remitting Funds

This section tells you how to account for remittances to the Internal Revenue Service, your state's regulatory department, and your local regulatory department.

To the Internal Revenue Service

To remit funds to the Internal Revenue Service for FIT, Social Security Tax, and Medicare Tax, you prepare a check and account for it with a journal entry in the General Journal.

The check should be for the total of the FIT Payable and Social Security/Medicare Payable account(s), and must be accompanied by an explanation of how much of the check is for each (usually a 941, Employer's Quarterly Federal Tax Return).

The journal entry made to account for the check should decrease the FIT Payable and Social Security/Medicare Payable account(s) for their outstanding balances and decrease the Cash in Bank account for the total amount of the payment.

A separate check to the Internal Revenue Service is required for the FUTA payment. To remit the FUTA funds, you prepare a check and account for it with a journal entry in the general journal. The check should be for the total of the FUTA Payable account, and must be accompanied by an explanation. At the end of the year, you will need to fill out a 940, Employer's Annual Federal Unemployment Tax Return.

You should check your *Circular E, Employer's Tax Guide* because the amounts you owe determine your payment frequency.

To the State Regulatory Department

To remit funds to your state's regulatory department, you prepare a check and account for it with a journal entry in the general journal. The check should be for the total of the SIT Payable (if your state requires SIT withholding), and must be accompanied by an explanation (usually with your state's standard reporting form). The journal entry made to account for the check should decrease the SIT Payable account for its outstanding balance and decrease the Cash in Bank account for the total amount of the payment.

If you contribute SUTA and your state also requires SUTA to be deducted from your employees, your SUTA Payable account will be the sum of your SUTA liability and the amount you deducted from your employees. If you want to know your portion of the SUTA Payable, you can look at the balance of your SUTA Expense account.

Similarly, if you contribute SDI and your state also requires SDI deductions from your employees, your SDI payable account will be the sum of your SDI liability and the amount deducted from their paychecks. Your portion of the SDI payable can be determined from your SDI expense account.

You should check with your state to determine your required payment frequency.

To the Local Regulatory Department

To remit funds to your local taxing jurisdiction, you prepare a check and account for it with a journal entry in the general journal. The check should be for the total of the Local Payable (if your jurisdiction requires certain withholding), and must be accompanied by an explanation. The journal entry made to account for the check should decrease the Local Payable account for its outstanding balance and decrease the Cash in Bank account for the total amount of the payment.

If you have a local payroll expense applicable only to employers, you should create general ledger accounts called Local Tax Expense and Local Tax Payable. You will need to calculate your required payment and increase the Local Tax Expense and the credit in Local Tax Payable. When you pay the check, decrease the Local Tax Payable and decrease Cash in Bank.

You should check with your local taxing jurisdiction to determine your required payment frequency and forms.

Chapter 19

Inventory Accounting

The inventory of a company can be defined as the materials and supplies which it uses in its day- to-day operations.

These materials and supplies may subsequently be sold, or used to produce new inventory assets, or simply consumed over a relatively short period of time, usually not exceeding one year. On this basis inventory is a current asset of a company.

Inventory assets may be acquired by direct purchase from suppliers. Ownership passes to the company at the point of delivery or at the point where the goods are **fob** (free on board), **fas** (free alongside ship), or **cif** (cost, insurance, and freight prepaid).

When the goods arrive, a **receiving** report should be prepared, a copy of which should be passed to the accounting department for subsequent matching to the supplier's invoice.

Inventory assets may also be produced by manufacture. In this case, new inventory items with higher value are created from existing inventory items of lower value.

A **manufacturing** report should be prepared and a copy passed to the accounting department to record the transfer of raw materials inventory to value added inventory.

Inventory assets are consumed (and consequently become an expense to the company) when they are sold. The revenue associated with the sale is recorded in an **invoice**, a copy of which is sent to the accounting department. The reduction in inventory associated with the sale and the expense associated with the original cost of the item would be accounted for concurrent with recording the sale.

Inventory assets may also be reduced by using them on the manufacture of new inventory assets. In this case, there is no

expense associated with the reduction of the raw material inventory because it adds a value equal to its cost to the new inventory item.

The **manufacturing** report indicates both the number of new inventory items created as well as the number of existing inventory items used.

Inventory assets may also be reduced by using them in a project. If ownership of the project remains with the company, then this type of transaction is similar to the prior example of lower value items being transferred to higher value items through manufacture.

In this case the project can be considered as an inventory item. Where the project is not owned by the company, the use of inventory on the project produces both a reduction in the inventory asset, and an expense associated with the cost of the item.

Inventory items being used on a project should be recorded by **requisitions**, which indicate the transfer of inventory to the project.

Inventory assets may also be reduced by loss arising from damage, spoilage, theft or obsolescence. In this case a **loss** report would be prepared and an accounting entry would be made to reduce the inventory asset and show an expense equal to the cost of the inventory item.

Accounting Control of Inventory

Accounting control of inventory can be carried out by several methods:

- First in, first out
- Last in, first out
- Average cost
- Item by item

Average cost is the simplest method and is the method discussed in the following paragraphs.

Average cost is a method of determining a unit cost for inventory based on adding the purchase cost of new inventory to the present cost of existing inventory, and then dividing this amount by the combined number of items in inventory.

When an existing inventory item is first purchased, its average cost is simply the purchase price divided by the number purchased. For example: if National Construction purchased 20 widgets for \$300, the average cost would be \$15. When items are removed from inventory they are removed at the average cost.

For example: if four items are requisitioned for a project, then the value of the remaining inventory is \$240, but the average cost is \$15.

If more inventory is bought at a price different from average cost, the average cost of the new inventory total would be changed. For example, if National Construction bought 16 more widgets for \$208, the new average cost would be calculated as follows:

16 units @	\$	15.00	=	\$	240.00
16 units @		13.00	=		<u>208.00</u>
					448.00
\$ 448.00 / 32			=	\$	14.00 (new average cost)

Inventory sold or used after this purchase now comes out of inventory at the new average cost of \$14 per widget.

For example: if at stock-taking time the number of units in inventory was found to be 30, a write-off of \$28 (2 units at the average price of \$14) in the value of inventory would have to be made to account for the loss of the two units. The unit price of the remaining inventory is still \$14.

An example of a Stock Control Card, illustrating the above valuation of inventory by the average cost method, is given below.

National Construction Stock Control Card								
Inventory Item No: 6040			Location: B-6L-5					
Description: Widgets			Product Line: A					
Supplier: Brown & Smith			Normal Delivery: 5 days					
Maximum Stock 32			Minimum Stock: 16					
Date	Comment	Doc. #	This Entry			Stock		
			Units	Cost	Total	Units	Cost	Total
01-08-95	Rec Report	R2769	20	15.00	300.00	20	15.00	300.00
01-12-95	Req	SR9274	-4	15.00	-60.00	16	15.00	240.00
01-23-95	P. Order	P6339	16					
01-28-95	Rec Report	R2807	16	13.00	208.00	32	14.00	448.00
01-31-95	Stocktake		-2	14.00	-28.00	30	14.00	420.00

General Ledger Accounts in Inventory Accounting

Manufacturers, wholesalers, and retailers would typically want to group their inventory asset accounts together in product categories on the balance sheet. Similarly, they would want to group revenue and expense associated with selling the inventory into similar product categories.

A typical structure to accomplish this is:

Smith Retailing Balance Sheet January 31, 1996			
Assets:		Liabilities:	
Current Assets		Current Liabilities	
Cash in Hand	\$ 10,000	Interest Payable	\$ 1,000
Cash in Bank	19,000	Wages Payable	1,000
Interest Receivable	600	Accounts Payable	20,000
Accounts Receivable	38,000	Operating Loan	<u>10,000</u>
Office Supplies	300	Total Current Liabilities	32,000
Prepaid Insurance	<u>1,000</u>		
Total Current Assets	68,900	Long-Term Liabilities	
		Mortgage	95,000
Inventory Assets		Bank Loan	<u>40,000</u>
Product Line A	9000	Total Long-Term Liabilities	135,000
Product Line B	12000		
Product Line C	<u>8000</u>	Total Liabilities	<u>167,000</u>
Total Inventory Assets	29,000		
		Equity:	
Fixed Assets		Retained Earnings	48,000
Land	70,000	Current Earnings	<u>30,000</u>
Buildings	40,000	Total Equity	<u>78,000</u>
Shop Fittings	15,100		
Warehouse Equip.	20,000	Total Liabilities & Equity	<u>\$245,000</u>
Office Furniture	<u>2,000</u>		
Total Fixed Assets	147,100		
Total Assets	<u>\$245,000</u>		

Smith Retailing Income Statement Feb. 1, 1995 - Jan. 31, 1996			
Revenue		Expenses	
Product Sales		Cost of Goods Sold	
Product Line A	\$133,000	Product Line A	\$ 79,300
Product Line B	69,000	Product Line B	42,800
Product Line C	<u>600</u>	Product Line C	<u>400</u>
Total Product Sales	202,600	Total Cost Goods Sold	122,500
Total Revenue	<u>\$202,600</u>	Administrative Expenses	
		Wages	27,000
		Depreciation	7,000
		Bad Debts	2,000
		Interest – Mortgage	5,600
		Interest – Bank Loan	2,600
		Interest – Optg Loan	800
		Professional Fees	1,300
		Telephone	800
		Insurance	2,300
		Utilities	<u>700</u>
		Total Administration	<u>50,100</u>
		Total Expenses	<u>172,600</u>
		Income	<u>\$ 30,000</u>

A frequent convention on the income statements for manufacturers, wholesalers, and retailers is to show the Gross Profit on Sales. This item is defined as follows:

Total Product Sales	\$ 202,600
Total Cost of Goods Sold	<u>122,500</u>
Gross Profit on Sales	80,100

Construction companies and other companies who use inventory items but who do not explicitly sell inventory items would normally use a different structure for their income statement, although their balance sheet would remain unchanged from the previous example. For example:

Universal Construction Income Statement Apr. 1, 1995 - Mar. 31, 1996			
Revenue		Expenses	
Sales		Construction	
Apartments	\$ 122,000	Material: Type A	\$ 39,000
Housing	64,000	Material: Type B	20,000
Office Building	600	Material: Type C	5,300
Total Sales	<u>186,600</u>	Rental: Excavators	4,000
		Rental: Crane	2,500
Miscellaneous Sales		Rental: Compressor	1,500
Engineering	2,000	Wages	30,000
Surveying	<u>4,000</u>	Wage Burden	<u>10,000</u>
Total Misc. Sales	<u>6,000</u>	Total Construction	112,300
Total Revenue	<u>\$ 192,600</u>	Administrative Expenses	
		Wages	27,000
		Depreciation	7,000
		Bad Debts	2,000
		Interest – Mortgage	5,600
		Interest – Bank Loan	2,800
		Interest – Optg Loan	800
		Professional Fees	1,300
		Telephone	800
		Insurance	2,300
		Utilities	<u>700</u>
		Total Administration	<u>50,300</u>
		Total Expenses	<u>162,600</u>
		Income	<u>\$ 30,000</u>

Tax Considerations in Accounting for Inventory

When you purchase and sell inventory items, you must account for state and local sales taxes.

State Sales Tax

When a company purchases an inventory item, it may have to pay a state sales tax, depending upon whether it is tax exempt or not. If the company is tax exempt, the purchase cost of inventory items is the amount paid to the supplier for the full cost of the goods. Suppose a company purchased an item for \$100 and it was exempt from state sales tax.

The journal entry for the purchase would be:

		<u>Debit</u>	<u>Credit</u>
1160	Product Line A	100.00	
1100	Cash		100.00

If the company is not tax exempt, the purchase cost of inventory items is the amount paid to the supplier plus state sales tax. For example, if the state sales tax rate was 6.5%, then the seller would charge for the tax explicitly.

The invoice would look like this:

Widget	\$ 100.00
State Sales Tax @ 6.5%	<u>6.50</u>
Total	\$ 106.50

The purchaser of the widget would record this addition to inventory with the following journal entry:

		<u>Debit</u>	<u>Credit</u>
1160	Product Line A	106.50	
1100	Cash		106.50

In a similar fashion, when a company sells an inventory item, the purchaser may or may not be exempt from state sales tax. If the purchaser is exempt from state sales tax, then you as seller would charge your regular selling price but would not add in state sales tax. Suppose you sold an item for \$100 and the purchaser was exempt from state sales tax.

The journal entry to record the sale would be:

		<u>Debit</u>	<u>Credit</u>
1100	Cash	100.00	
4160	Product A Revenue		100.00

If the purchaser is not exempt from state sales tax, then you as seller must charge for it. If the state sales tax rate is 6.5%, then the journal entry that is produced when you sell an item for \$100 and charge for state sales tax is:

		<u>Debit</u>	<u>Credit</u>
1100	Cash	106.50	
4160	Product A Revenue		100.00
2160	State Sales Tax Payable		6.50

The state sales tax rate will vary according to the state; however, it will not vary within the state itself.

Local Sales Tax

If you sell an item to a purchaser who is not exempt from local sales tax, you will have to collect this tax on all items that are subject to local sales tax. The local sales tax rate is usually added to the state sales tax rate, and then the combined rate is applied to the selling price.

Following with the above example, assume the local sales tax rate is 1.5%. When combined with the state sales tax rate of 6.5%, the tax of 8% is applied to the \$100 selling price of the item. The journal entry would be:

		<u>Debit</u>	<u>Credit</u>
1100	Cash	108.00	
4160	Product A Revenue		100.00
2160	Sales Tax Payable		8.00

Local sales tax rates will vary according to the local authority having jurisdiction; however, they will not vary within that jurisdiction.

When it comes time to remit your state and local taxes to the government, you must remit the total amount collected for both to the state government. The state government is responsible for disbursing the correct amount of local sales tax to the local government.

When a check is produced, you must decrease the Sales Tax Payable account by the amount due for remittance. At the same time you must decrease your cash account by the total remittance.

Chapter 20

Cost Accounting

Cost accounting is a system of allocating costs and/or expenses incurred to a particular division, department or project so that management can quickly determine if the division, department or project is meeting its budget or is earning money.

Project Costs

This is how costs can be allocated to different projects.

If during February, an employee was paid \$3,000, their wages would be recorded in the ledger as follows:

Feb 14, 95	Wage Expense	5020	3,000	
	Cash in Bank	1020		3,000
	Jones paid for March			

During the month, the employee spent 50% of their time on project A, 25% on Project B, and 25% on Project C. Therefore, while making the above journal entry, the employer would allocate \$1,500 to Project A, \$750 to Project B, and \$750 to Project C.

If the employer allocated expenses incurred during March to the three projects in a similar manner, at the end of the month a project cost report could be generated for the two month period.

	Projects		
	A	B	C
Wages	\$ 5,000	\$ 7,000	\$ 2,000
Supplies	1,000	700	3,000
Equipment Rental	<u>3,000</u>	<u>1,000</u>	<u>2,000</u>
Total Costs	\$ <u>9,000</u>	\$ <u>8,700</u>	\$ <u>7,000</u>

This information is useful to the employer because it shows how much each project has cost to date, and the breakdown of the costs. The employer is now in a better position to be able to control costs and make decisions regarding the projects.

Profit Centers

Cost accounting can also be used to determine the profitability of any **profit center** such as a division, department, or region.

Here is an example in which a hotel determines which departments are profitable. As revenue and expense transactions are recorded in the journal, the revenues and expenses are also allocated to the departments that are responsible for them. Some expenses are shared between departments in the same way that expenses were shared between projects in the previous example.

At the end of every month, the reports on the departments are prepared and summarized. Ordinarily, much more detail would be presented, but this example only classifies revenue and expenses into broad categories.

Westridge Hotel			
	Bar	Dining Room	Rooms
Revenues			
Food	\$ 1,000	\$ 12,000	—
Alcohol	8,000	6,000	—
Rental	<u>—</u>	<u>—</u>	\$ <u>20,000</u>
Total	9,000	18,700	20,000
Expenses			
Food and Beverages	4,000	6,000	—
Wages	4,000	6,000	8,000
Utilities and Supplies	<u>500</u>	<u>2,000</u>	<u>2,000</u>
Total	<u>8,500</u>	<u>14,000</u>	<u>10,000</u>
Profit	\$ <u>500</u>	\$ <u>4,000</u>	\$ <u>10,000</u>

Glossary

Account — Each separate category of asset, liability, equity, revenue or expense for which transactions are recorded separately. An account can have a debit or credit balance. Account records are usually kept as separate pages in a book called a ledger. Accounts are sometimes called ledger accounts.

Accounting Equation — The basis for the entire accounting process: $\text{Assets} = \text{Liabilities} + \text{Equity}$.

Accounting Period — The period of time over which a company's business transactions are recorded and at the end of which the company's financial statements are printed. Most accounting systems have an accounting period of one month.

Accounts Payable — Money owed by the company for goods and services provided by its suppliers.

Accrual Method — A method of stating income whereby revenues are recognized in the accounting period in which they are earned, not when the payment is received. Most businesses are required by law to use the accrual method of accounting.

Accrued Expenses — Expenses which have been incurred but have not yet been paid and recorded in the books because no invoice has been received.

Adjustments — Journal entries to record accrued expenses, depreciation, accrued revenues, bad debts, and other items which must be recorded at the end of the accounting period in order to state income accurately. The journal entries to record adjustments are called adjusting entries.

Assets — All the physical things and other items of value owned by a company. They are listed on the left side of the balance sheet. Assets include finished and unfinished inventory, land, buildings, cash, and money owed to the company by customers.

Bad Debts — The amounts not paid when a customer fails to pay all or part of what is owed. You make an adjusting entry to record it as an expense.

Balance Sheet — A summary of what a company owns and owes on a particular day. It has three main categories: assets, liabilities, and equity.

Chart of Accounts — A list of the accounts in a ledger, arranged by account number.

Classified Statements — Financial statements that group accounts into sets that give similar information. For example, typical classifications on a balance sheet would be current assets, long-term investments, plant and equipment, current liabilities, and long-term liabilities.

Closing the Books — The process of posting closing entries to clear the revenue and expense accounts and to transfer the net income to the Retained Earnings account at the end of an accounting year. It is done to ensure that the books are ready to record the next accounting year's transactions. When you close the books, the balance of the Current Earnings account is transferred to the Retained Earnings account.

Common Shares — Shares that have no preference as to dividends and no fixed rate of return. This is the most common type of share, and normally has voting rights attached to it. Since common shares are typically the only type of shares with voting rights, the shareholders who control the majority of the common shares usually control the company.

Corporation — A form of business organization which is legally separate from its owners, and in which the owners (called shareholders) have limited liability. Owners can only lose what they have invested in the corporation. A corporation has the right to sue and be sued by others. A corporation is also called a limited company. See also: Shareholders.

Cost Accounting — A system of allocating costs or expenses to a particular job, department, or project so that a company's management can quickly determine whether the project is meeting its budget or earning the company any profits.

Cost of Goods Manufactured — The cost of the raw materials, direct labor, and factory overhead incurred in producing all the goods manufactured during a period.

Cost of Goods Sold — The cost of the raw materials, direct labor, and factory overhead incurred in producing all the goods sold during a period.

Current Assets — Assets which can be converted to cash or realized in the ordinary course of business, usually within one year.

Current Earnings — The net difference between the revenue account totals and the expense account totals. There is only one Current Earnings account on the balance sheet. Every time a journal entry is made that affects revenue or expense accounts, the balance in the Current Earnings account is recalculated. You cannot post journal entries directly

to this account. Its balance is printed on the right side of the balance sheet. When you close the books at year end, the balance in the Current Earnings account is transferred to the Retained Earnings account.

Current Liabilities — Debts that are payable within one year of the balance sheet date, and which will require the use of a current asset.

Credit — A positive balance on the right-hand side of an account. Increasing the balance of an account with a normal credit balance is called crediting, as is decreasing the balance of an account which normally has a debit balance.

Debit — A positive balance on the left-hand side of an account. Increasing the balance of an account which normally has a debit balance is called debiting, as is decreasing the balance of an account which normally has a credit balance.

Depreciation — Allocation of the cost of a physical asset (such as a piece of equipment) over its useful life. Depreciation transactions debit the depreciation expense account and credit (reduce) the value of the asset.

Direct Labor Costs — Wages paid to employees (laborers and supervisors) who work directly on the product being manufactured.

Dividend — A payment made to shareholders by a corporation, usually out of after-tax profits. The directors of the company make the decision for the company to declare and pay dividends.

Earnings — See: Current Earnings, Retained Earnings.

Equity — The worth of a business to its owner. It is shown on the right side of the balance sheet. To calculate the owner's equity, subtract the liabilities from the assets.

Expenses — The amounts that a company spends to provide goods or services to its customers or to carry on its business, excluding amounts spent to acquire assets.

Factory Overhead — All costs incurred in the factory, other than the costs of raw materials and direct labor. Included are costs such as management wages, janitorial wages, and the costs of using and maintaining buildings, machinery, and equipment.

Financial Statements — The balance sheet and income statement.

Fiscal Year — The twelve-month period which a company chooses for accounting purposes. It is not necessarily the same as a calendar year.

Fixed Assets — Assets such as land, buildings, equipment, and trucks that are used in operating the business and which have a long life.

Gross Profit on Sales — The profit made on selling inventory before the selling and general and administrative expenses are taken into account. It is the value of Sales less the Cost of Goods Sold.

Income — See: Net Income.

Income Statement — A statement which shows the revenues, expenses, and net income for a particular period.

Inventory — The goods a business has for sale to its customers. For retailers or wholesalers, the goods themselves are not modified in any major way from the time they are received to the time they are sold. A manufacturing company's inventory consists of raw materials, work in process, and finished products manufactured but not yet sold.

Journal — A company's primary record of business transactions. All transactions recorded by a business are recorded first in a journal. See also: Journal Entry.

Journal Entry — The record of a transaction in a journal.

Ledger — A book in which each page contains the records of one account. See also: Account.

Liabilities — All the debts and money owed to others by a company. They are listed on the right side of the balance sheet. Liabilities include loans from banks, loans from shareholders, and unpaid amounts owed to suppliers and others.

Long Term Liabilities — Liabilities that are not due to be paid within the year following the balance sheet date.

Matching Concept — A method of matching expenses with the revenues that they help generate, and recording them at the time that revenues are recorded.

Net Income — The amount left over after all the revenues for a period are accounted for, and all costs and expenses for the same period are deducted. Net income is also called income, profit, or net loss (if the income amount is negative).

Net Sales — See: Revenues.

Opening the Books — The process of setting up a new set of books with the correct balance sheet account balances, and zero balances in the revenue and expense accounts. When this is done, the new books are ready to record the upcoming accounting year's transactions.

Owner Equity — The interest or stake the owners have in a company. It is the owners' original investment plus the accumulation of all profits that have been retained in the company since its conception. To calculate owner equity, subtract the liabilities from the assets. See also: Shareholders' Equity.

Partnership — A form of proprietorship in which there is more than one owner. The owners have unlimited liability, and any one of them could be sued separately for the entire debts of the partnership. The partners usually agree to share the profits and losses of the firm on an equitable basis. See also: Proprietorship.

Posting — The process of transferring information from the journal to the applicable ledger account.

Preferred Shares — Shares that may pay their owners a dividend, which is usually fixed in amount or percent. Preferred shareholders receive their dividends before the common shareholders are entitled to any dividends. See also: Dividends.

Prepaid Expenses — Expenses which are paid for in advance, such as insurance and rent. Prepaid expenses are current assets.

Profit — The amount left over after all the revenues for a period are accounted for, and all costs and expenses for the same period are deducted. Profit is also called net profit, income, or net income.

Profit Center — A department, sales region, project, or any other part of a company for which revenues and expenses can be identified.

Proprietorship — A form of business organization in which the owner and the company are not legally separate, but keep separate accounting records. A proprietor (the owner) has unlimited liability. He can be sued personally for the debts of his company.

Realization — The recording of revenues or expenses. Revenue is realized when the title to goods or services passes to the customer. Expenses are realized when they are incurred, or, if they can be matched to a certain good or service provided, they are recorded at the time the revenue for that particular good or service is recorded. See also: Matching Concept.

Retained Earnings — The accumulated total of after-tax profits and losses over the life of a corporation. If a corporation had more losses than profits, the amount of retained earnings is negative. Any dividends paid are also subtracted from retained earnings. See also: Earnings.

Revenues — The money that a company receives from selling products or services.

Sales — See: Revenues.

Shareholders — Persons or other companies that own shares (stock) issued by a corporation. The shareholders own the corporation, but are legally separate from the corporation. They have limited liability and can only lose what they originally invested in the corporation.

Shareholders' Equity — The money originally invested in the company by the shareholders, plus the retained earnings. See also: Retained Earnings; Owner Equity.

Shares — Certificates that represent ownership of a portion of a firm. Shares are also called stock. See also: Preferred Shares; Common Shares.

Stock — See: Shares.

Source Document — An invoice or a bill on which the transaction recorded by a journal entry is based.

Subsidiary Ledger — A ledger which contains the details for a General Ledger control account. For example, the accounts receivable subsidiary ledger contains the details of all amounts owed to the company by its customers. The total of these amounts is summarized by the Accounts Receivable control account in the general ledger.

Trial Balance — A list of all the debit and credit balances of all the accounts in the general ledger. Use it to ensure that there have been no posting or adding mistakes, and that the total debits equal the total credits.

Withdrawal — The money taken out of a company by a proprietor or partner.

Worksheet — A list of all the accounts in the ledger, used to work out the balance sheet and income statement in a manual accounting system. The worksheet is created directly from the trial balance.

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