

# FINANCIAL ACCOUNTING: FOUNDATIONS



OKTAY URCAN



## Recording Transactions and Financial Statement Preparation

Introduction



# MODULE OVERVIEW

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- Recording financial transactions
- Preparing balance sheet
- Preparing income statement



# RECORDING FINANCIAL TRANSACTIONS

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- **Fundamental accounting equation:**  
$$\text{Assets} = \text{Liabilities} + \text{Shareholders' equity}$$
- Thus, we have for over any period of time:  
$$\Delta \text{ Assets} = \Delta \text{ Liabilities} + \Delta \text{ Shareholders' equity}$$
- This equation constitutes the foundation of recording financial transactions.



# RECORDING FINANCIAL TRANSACTIONS

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How to record financial transactions:

- ✓ Identify which accounts are impacted
- ✓ Determine the impact on each account
- ✓ Ensure that fundamental accounting equation  
[ $\Delta \text{Assets} = \Delta \text{Liabilities} + \Delta \text{Shareholders' equity}$ ] holds



# EXAMPLE 1

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A firm purchases a truck for \$65,000 with a bank loan.

This transaction impacts two accounts:

- ✓ Fixed assets (which is a part of assets) increases by \$65,000
- ✓ Bank loan (which is a part of liabilities) increases by \$65,000



# HOW TO RECORD FINANCIAL TRANSACTIONS



Transaction Worksheet					
	Assets	=	Liabilities	+	Shareholders' equity
Opening balance					
Transactions					
Closing balance					

# EXAMPLE 1



**A firm purchases a truck for \$65,000 with a bank loan.**

	<b>Assets</b>	<b>=</b>	<b>Liabilities</b>	<b>+</b>	<b>Shareholders' equity</b>
Purchase of a truck	\$65,000		\$65,000		



**Fixed Assets**



**Bank Loan**



# EXAMPLE 1



**A firm purchases a truck for \$65,000 with a bank loan.**

	<b>Assets</b>	<b>=</b>	<b>Liabilities</b>	<b>+</b>	<b>Shareholders' equity</b>
Purchase of a truck	\$65,000		\$65,000		

$\Delta \text{ Assets} =$   
\$65,000

$\Delta \text{ Liabilities} =$   
\$65,000

✓ Fundamental accounting equation [ $\Delta \text{ Assets} = \Delta \text{ Liabilities} + \Delta \text{ Shareholders' equity}$ ] holds





# EXAMPLE 2



A firm sells goods which originally cost \$1000 for \$1,500 in cash.					
	Assets	=	Liabilities	+	Shareholders' equity
Sales Cost of sales					



# EXAMPLE 2



A firm sells goods which originally cost \$1000 for \$1,500 in cash.					
	Assets	=	Liabilities	+	Shareholders' equity
Sales Cost of sales	\$1,500				\$1,500
<div>Cash</div>					<div>Income Statement</div>

# EXAMPLE 2



A firm sells goods which originally cost \$1000 for \$1,500 in cash.					
	Assets	=	Liabilities	+	Shareholders' equity
Sales Cost of sales	\$ 1,500 (\$ 1,000)				\$ 1,500 (\$ 1,000)
					
	Inventories				Income Statement

# EXAMPLE 2



A firm sells goods which originally cost \$1000 for \$1,500 in cash.

	Assets	=	Liabilities	+	Shareholders' equity
Sales Cost of sales	\$ 1,500 (\$ 1,000)				\$ 1,500 (\$ 1,000)

$\Delta \text{Assets} =$   
\$500

$\Delta \text{SHE} = \$500$

✓ Fundamental accounting equation [ $\Delta \text{Assets} = \Delta \text{Liabilities} + \Delta \text{Shareholders' equity}$ ] holds



# EXAMPLE 3



A firm receives a utility bill of \$850.

	Assets	=	Liabilities	+	Shareholders' equity
Utility bill					

# EXAMPLE 3



A firm receives a utility bill of \$850.					
	Assets	=	Liabilities	+	Shareholders' equity
Utility bill			\$850		(\$850)

Accounts Payable

Income Statement

# EXAMPLE 3



A firm receives a utility bill of \$850.

	Assets	=	Liabilities	+	Shareholders' equity
Utility bill			\$850		(\$850)

$\Delta \text{ Liabilities} =$   
\$850

$\Delta \text{ SHE} = (\$850)$

✓ Fundamental accounting equation [ $\Delta \text{ Assets} = \Delta \text{ Liabilities} + \Delta \text{ Shareholders' equity}$ ] holds



# FINANCIAL ACCOUNTING: FOUNDATIONS



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## Recording Transactions and Financial Statement Preparation

Example: Illinois Supermarket





# EXAMPLE: ILLINOIS SUPERMARKET

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Jack sets up a supermarket on January 1, 2016, which sells groceries in Central Illinois by investing \$15,000 of his own money and getting a \$30,000 bank loan with 10% annual interest rate. Bank loan is payable in 6 years.



# EXAMPLE: ILLINOIS SUPERMARKET

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The supermarket has the following transactions in Year 1:

- Purchase a shop for \$10,000 cash
- Purchase groceries for \$5,000 on credit
- Pay annual insurance premium of \$1,000
- Sell groceries (originally costing \$3,000) for \$5,000 in cash
- Pay creditors \$4,000
- Pay utilities \$2,000
- Pay employees \$2,000
- Pay annual interest of the bank loan



	Assets			Liabilities		Shareholders' equity		
	Cash	Inventory	PPE	Accounts Payable	Bank Loan	Common Stock	Income Statement	Retained Earnings
Initial capital	15					15		
Bank loan								
Shop								
Groceries								
Insurance								
Sales								
Cost of sales								
Creditors								
Utilities								
Employees								
Interest								
Transfer to retained profit								
Ending Balance								



	Assets			Liabilities		Shareholders' equity		
	Cash	Inventory	PPE	Accounts Payable	Bank Loan	Common Stock	Income Statement	Retained Earnings
Initial capital	15					15		
Bank loan	30				30			
Shop								
Groceries								
Insurance								
Sales								
Cost of sales								
Creditors								
Utilities								
Employees								
Interest								
Transfer to retained profit								
Ending Balance								



	Assets			Liabilities		Shareholders' equity		
	Cash	Inventory	PPE	Accounts Payable	Bank Loan	Common Stock	Income Statement	Retained Earnings
Initial capital	15					15		
Bank loan	30				30			
Shop	(10)		10					
Groceries								
Insurance								
Sales								
Cost of sales								
Creditors								
Utilities								
Employees								
Interest								
Transfer to retained profit								
Ending Balance								



	Assets			Liabilities		Shareholders' equity		
	Cash	Inventory	PPE	Accounts Payable	Bank Loan	Common Stock	Income Statement	Retained Earnings
Initial capital	15					15		
Bank loan	30				30			
Shop	(10)		10					
Groceries		5		5				
Insurance								
Sales								
Cost of sales								
Creditors								
Utilities								
Employees								
Interest								
Transfer to retained profit								
Ending Balance								



	Assets			Liabilities		Shareholders' equity		
	Cash	Inventory	PPE	Accounts Payable	Bank Loan	Common Stock	Income Statement	Retained Earnings
Initial capital	15					15		
Bank loan	30				30			
Shop	(10)		10					
Groceries		5		5				
Insurance	(1)						(1)	
Sales								
Cost of sales								
Creditors								
Utilities								
Employees								
Interest								
Transfer to retained profit								
Ending Balance								





	Assets			Liabilities		Shareholders' equity		
	Cash	Inventory	PPE	Accounts Payable	Bank Loan	Common Stock	Income Statement	Retained Earnings
Initial capital	15					15		
Bank loan	30				30			
Shop	(10)		10					
Groceries		5		5				
Insurance	(1)						(1)	
Sales	5						5	
Cost of sales		(3)					(3)	
Creditors								
Utilities								
Employees								
Interest								
Transfer to retained profit								
Ending Balance								





	Assets			Liabilities		Shareholders' equity		
	Cash	Inventory	PPE	Accounts Payable	Bank Loan	Common Stock	Income Statement	Retained Earnings
Initial capital	15					15		
Bank loan	30				30			
Shop	(10)		10					
Groceries		5		5				
Insurance	(1)						(1)	
Sales	5						5	
Cost of sales		(3)					(3)	
Creditors	(4)			(4)				
Utilities								
Employees								
Interest								
Transfer to retained profit								
Ending Balance								



	Assets			Liabilities		Shareholders' equity		
	Cash	Inventory	PPE	Accounts Payable	Bank Loan	Common Stock	Income Statement	Retained Earnings
Initial capital	15					15		
Bank loan	30				30			
Shop	(10)		10					
Groceries		5		5				
Insurance	(1)						(1)	
Sales	5						5	
Cost of sales		(3)					(3)	
Creditors	(4)			(4)				
Utilities	(2)						(2)	
Employees								
Interest								
Transfer to retained profit								
Ending Balance								



	Assets			Liabilities		Shareholders' equity		
	Cash	Inventory	PPE	Accounts Payable	Bank Loan	Common Stock	Income Statement	Retained Earnings
Initial capital	15					15		
Bank loan	30				30			
Shop	(10)		10					
Groceries		5		5				
Insurance	(1)						(1)	
Sales	5						5	
Cost of sales		(3)					(3)	
Creditors	(4)			(4)				
Utilities	(2)						(2)	
Employees	(2)						(2)	
Interest								
Transfer to retained profit								
Ending Balance								



	Assets			Liabilities		Shareholders' equity		
	Cash	Inventory	PPE	Accounts Payable	Bank Loan	Common Stock	Income Statement	Retained Earnings
Initial capital	15					15		
Bank loan	30				30			
Shop	(10)		10					
Groceries		5		5				
Insurance	(1)						(1)	
Sales	5						5	
Cost of sales		(3)					(3)	
Creditors	(4)			(4)				
Utilities	(2)						(2)	
Employees	(2)						(2)	
Interest	(3)						(3)	
Transfer to retained profit	<div> <math>\\$30,000 * 10\%</math>  <math>= \\$3,000</math> </div>							
Ending Balance								



	Assets			Liabilities		Shareholders' equity		
	Cash	Inventory	PPE	Accounts Payable	Bank Loan	Common Stock	Income Statement	Retained Earnings
Initial capital	15					15		
Bank loan	30				30			
Shop	(10)		10					
Groceries		5		5				
Insurance	(1)						(1)	
Sales	5						5	
Cost of sales		(3)					(3)	
Creditors	(4)			(4)				
Utilities	(2)						(2)	
Employees	(2)						(2)	
Interest	(3)						(3)	
Transfer to retained profit							6	(6)
Ending Balance								



	Assets			Liabilities		Shareholders' equity		
	Cash	Inventory	PPE	Accounts Payable	Bank Loan	Common Stock	Income Statement	Retained Earnings
Initial capital	15					15		
Bank loan	30				30			
Shop	(10)		10					
Groceries		5		5				
Insurance	(1)						(1)	
Sales	5						5	
Cost of sales		(3)					(3)	
Creditors	(4)			(4)				
Utilities	(2)						(2)	
Employees	(2)						(2)	
Interest	(3)						(3)	
Transfer to retained profit							6	(6)
Ending Balance	28	2	10	1	30	15		(6)



	Assets			Liabilities		Shareholders' equity		
	Cash	Inventory	PPE	Accounts Payable	Bank Loan	Common Stock	Income Statement	Retained Earnings
Initial capital	15					15		
Bank loan	30				30			
Shop	(10)		10					
Groceries		5		5				
Insurance	(1)						(1)	
Sales	5						5	
Cost of sales		(3)					(3)	
Creditors	(4)			(4)				
Utilities	(2)						(2)	
Employees	(2)						(2)	
Interest	(3)						(3)	
Transfer to retained profit	Ending Balances are used to prepare the Balance Sheet.							
Ending Balance	28	2	10	1	30	15		(6)





# ILLINOIS SUPERMARKET: BALANCE SHEET

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Current Assets	December 2016
Cash	\$28,000
Inventories	\$2,000
Fixed Assets	\$10,000
<b>Total Assets</b>	<b>\$40,000</b>
Current Liabilities	
Accounts payable	\$1,000
Long-term Liabilities	
Bank loan	\$30,000
Shareholders' equity	
Common stock	\$15,000
Retained earnings	<u>(\$6,000)</u>
<b>Liabilities and Shareholders' equity</b>	<b>\$40,000</b>





	Assets			Liabilities		Shareholders' equity		
	Cash	Inventory	PPE	Accounts Payable	Bank Loan	Common Stock	Income Statement	Retained Earnings
Initial capital	15					15		
Bank loan	30				30			
Shop	(10)		10					
Groceries		5		5				
Insurance	(1)						(1)	
Sales	5						5	
Cost of sales		(3)					(3)	
Creditors	This column is used to prepare the Income Statement.							
Utilities	(2)						(2)	
Employees	(2)						(2)	
Interest	(3)						(3)	
Transfer to retained profit							6	(6)
Ending Balance	28	2	10	1	30	15		(6)



# ILLINOIS SUPERMARKET: INCOME STATEMENT

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	<u>Year 2016</u>
Sales	\$5,000
Cost of Goods Sold	<u>(\$3,000)</u>
Gross Profit	\$2,000
Operating Expenses	<u>(\$5,000)</u>
Profit before Interest	(\$3,000)
Interest Expense	<u>(\$3,000)</u>
Net Income	(\$6,000)



# ILLINOIS SUPERMARKET

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Illinois Supermarket has the following transactions in year 2017:

- Purchase groceries for \$10,000 on credit
- Pay annual insurance premium of \$1,000
- Sell groceries (originally costing \$7,000) for \$25,000 on credit
- Pay creditors \$8,000
- Pay utilities \$3,000
- Pay employees \$5,000
- Pay annual interest of the bank loan
- Declare (but not pay) dividends of \$2,000
- Corporate tax rate is 50%



[illegible]

	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Beginning balance	28	2	0	10	0	0	1	30	15		(6)
Groceries											
Insurance											
Sales											
Cost of sales											
Creditors											
Utilities											
Employees											
Interest											
Dividends											
Tax											
Transfer to RE											
Ending Balance											

	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Beginning balance	28	2	0	10	0	0	1	30	15		(6)
Groceries		10					10				
Insurance											
Sales											
Cost of sales											
Creditors											
Utilities											
Employees											
Interest											
Dividends											
Tax											
Transfer to RE											
Ending Balance											



	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Beginning balance	28	2	0	10	0	0	1	30	15		(6)
Groceries		10					10				
Insurance	(1)									(1)	
Sales											
Cost of sales											
Creditors											
Utilities											
Employees											
Interest											
Dividends											
Tax											
Transfer to RE											
Ending Balance											





	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Beginning balance	28	2	0	10	0	0	1	30	15		(6)
Groceries		10					10				
Insurance	(1)									(1)	
Sales			25							25	
Cost of sales		(7)								(7)	
Creditors											
Utilities											
Employees											
Interest											
Dividends											
Tax											
Transfer to RE											
Ending Balance											





	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Beginning balance	28	2	0	10	0	0	1	30	15		(6)
Groceries		10					10				
Insurance	(1)									(1)	
Sales			25							25	
Cost of sales		(7)								(7)	
Creditors	(8)						(8)				
Utilities											
Employees											
Interest											
Dividends											
Tax											
Transfer to RE											
Ending Balance											



	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Beginning balance	28	2	0	10	0	0	1	30	15		(6)
Groceries		10					10				
Insurance	(1)									(1)	
Sales			25							25	
Cost of sales		(7)								(7)	
Creditors	(8)						(8)				
Utilities	(3)									(3)	
Employees											
Interest											
Dividends											
Tax											
Transfer to RE											
Ending Balance											



	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Beginning balance	28	2	0	10	0	0	1	30	15		(6)
Groceries		10					10				
Insurance	(1)									(1)	
Sales			25							25	
Cost of sales		(7)								(7)	
Creditors	(8)						(8)				
Utilities	(3)									(3)	
Employees	(5)									(5)	
Interest											
Dividends											
Tax											
Transfer to RE											
Ending Balance											



	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Beginning balance	28	2	0	10	0	0	1	30	15		(6)
Groceries		10					10				
Insurance	(1)									(1)	
Sales			25							25	
Cost of sales		(7)								(7)	
Creditors	(8)						(8)				
Utilities	(3)									(3)	
Employees	(5)									(5)	
Interest	(3)									(3)	
Dividends											
Tax											
Transfer to RE											
Ending Balance											



	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Beginning balance	28	2	0	10	0	0	1	30	15		(6)
Groceries		10					10				
Insurance	(1)									(1)	
Sales			25							25	
Cost of sales		(7)								(7)	
Creditors	(8)						(8)				
Utilities	(3)									(3)	
Employees	(5)									(5)	
Interest	(3)									(3)	
Dividends					2						(2)
Tax											
Transfer to RE											
Ending Balance											



	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Beginning balance	28	2	0	10	0	0	1	30	15		(6)
Groceries		10					10				
Insurance	(1)									(1)	
Sales			25							25	
Cost of sales		(7)								(7)	
Creditors	(8)						(8)				
Utilities	(3)									(3)	
Employees	(5)									(5)	
Interest	(3)									(3)	
Dividends					2						(2)
Tax						3				(3)	
Transfer to RE											
Ending Balance											

Net Income before Tax = \$6,000  
Tax Rate = 50%  
Tax Expense = \$3,000



	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Beginning balance	28	2	0	10	0	0	1	30	15		(6)
Groceries		10					10				
Insurance	(1)									(1)	
Sales			25							25	
Cost of sales		(7)								(7)	
Creditors	(8)						(8)				
Utilities	(3)									(3)	
Employees	(5)									(5)	
Interest	(3)									(3)	
Dividends					2						(2)
Tax						3				(3)	
Transfer to RE										(3)	3
Ending Balance											





	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Beginning balance	28	2	0	10	0	0	1	30	15		(6)
Groceries		10					10				
Insurance	(1)									(1)	
Sales			25							25	
Cost of sales		(7)								(7)	
Creditors	(8)						(8)				
Utilities	(3)									(3)	
Employees	(5)									(5)	
Interest	(3)									(3)	
Dividends					2						(2)
Tax						3				(3)	
Transfer to RE										(3)	3
Ending Balance	8	5	25	10	2	3	3	30	15		(5)



	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Beginning balance	28	2	0	10	0	0	1	30	15		(6)
Groceries		10					10				
Insurance	(1)									(1)	
Sales			25							25	
Cost of sales		(7)								(7)	
Creditors	(8)						(8)				
Utilities	(3)									(3)	
Employees	(5)									(5)	
Interest	(3)									(3)	
Dividends					2						(2)
Tax											
Ending Balances are used to prepare the Balance Sheet.											
Transfer to RE										(3)	3
Ending Balance	8	5	25	10	2	3	3	30	15		(5)

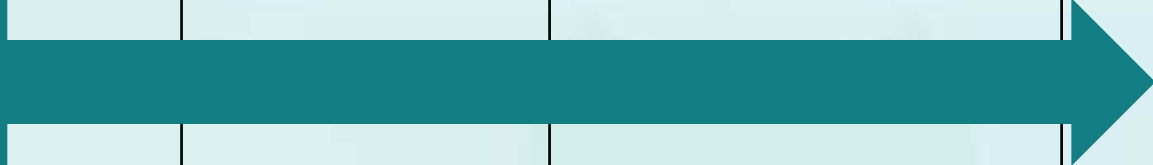


# ILLINOIS SUPERMARKET: BALANCE SHEET



Current Assets	December 2017
Cash	\$8,000
Inventories	\$5,000
Accounts receivables	\$25,000
Fixed Assets	\$10,000
<b>Total Assets</b>	<b>\$48,000</b>
Current Liabilities	
Dividends payable	\$2,000
Tax payable	\$3,000
Accounts payable	\$3,000
Long-term Liabilities	
Bank loan	\$30,000
Shareholders' equity	
Common stock	\$15,000
Retained earnings	<u>(\$5,000)</u>
<b>Liabilities and Shareholders' equity</b>	<b>\$48,000</b>



	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Beginning balance	28	2	0	10	0	0	1	30	15		(6)
Groceries		10					10				
Insurance	(1)									(1)	
Sales			25							25	
Cost of sales		(7)								(7)	
Creditors	(8)						(8)				
Utilities	This column is used to prepare the Income Statement. 									(3)	
Employees										(5)	
Interest										(3)	
Dividends											(2)
Tax					2	3				(3)	
Transfer to RE										(3)	3
Ending Balance	8	5	25	10	2	3	3	30	15		(5)



# ILLINOIS SUPERMARKET: INCOME STATEMENT

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	<u>Year 2017</u>
Sales	\$25,000
Cost of Goods Sold	<u>(\$7,000)</u>
Gross Profit	\$18,000
Operating Expenses	<u>(\$9,000)</u>
Profit before Interest and Tax	\$9,000
Interest Expense	<u>(\$3,000)</u>
Profit before Tax	\$6,000
Tax Expense	<u>(\$3,000)</u>
Net Income	<b>\$3,000</b>



# FINANCIAL ACCOUNTING: FOUNDATIONS



OKTAY URCAN



## Recording Transactions and Financial Statement Preparation

Individual Accounts



# HOW DO INDIVIDUAL ACCOUNTS CHANGE?

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Individual accounts change during a period as follows:

$$\begin{aligned} &\text{Beginning Balance} \\ &+ \text{Additions during the period} \\ &- \text{Reductions during the period} \\ &= \text{Ending Balance} \end{aligned}$$





# EXAMPLE: INDIVIDUAL ACCOUNTS

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What is the cash paid to suppliers in year 2017 for Illinois Supermarket?

## Accounts Payable

Beginning Balance \$1,000

+ Additions during the period \$10,000

– Reductions during the period (?)

= Ending Balance \$3,000

? = \$8,000



# FINANCIAL ACCOUNTING: FOUNDATIONS



OKTAY URCAN



## Recording Transactions and Financial Statement Preparation

Accrual Accounting



# ACCRUAL ACCOUNTING

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Recall the following transactions of Illinois Supermarket in Year 2:

- Pay annual insurance premium of \$1,000
- Pay employees \$5,000



# IN-VIDEO QUESTION

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What happens if:

- Half of the insurance payment (\$500) is prepayment for the next year's insurance?
- Employees earn \$5,000 but are not paid yet?



# ACCRUAL ACCOUNTING



Original Solution											
	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Insurance Employees	(1) (5)									(1) (5)	

# ACCRUAL ACCOUNTING



Original Solution											
	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Insurance Employees	(1) (5)									(1) (5)	

Updated Solution											
	Assets				Liabilities				Shareholders' equity		
	Cash	Prepaid expenses			Accounts payable			Bank Loan	Common Stock	IS	RE
Insurance Employees											

# ACCRUAL ACCOUNTING



Original Solution											
	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Insurance Employees	(1) (5)									(1) (5)	

Updated Solution											
	Assets				Liabilities				Shareholders' equity		
	Cash	Prepaid expenses			Accounts payable			Bank Loan	Common Stock	IS	RE
Insurance Employees	(1)	0.5								(0.5)	



# ACCRUAL ACCOUNTING



Original Solution											
	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Insurance Employees	(1) (5)									(1) (5)	

Updated Solution											
	Assets				Liabilities				Shareholders' equity		
	Cash	Prepaid expenses			Accounts payable			Bank Loan	Common Stock	IS	RE
Insurance Employees	(1)	0.5			5					(0.5) (5)	

# ACCRUAL ACCOUNTING

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- **Accrual accounting** uses **adjusting entries** to reflect economic reality even when there is no cash involved in the transaction.
- Under accrual accounting, revenues are recognized when earned and expenses are recognized when incurred.
- Thus, profits are NOT equal to cash over a period.



	Assets				Liabilities				Shareholders' equity		
	Cash	INV	AR	PPE	DP	TP	AP	Bank Loan	Common Stock	IS	RE
Beginning balance	28	2	0	10	0	0	1	30	15		(6)
Groceries		10					10				
Insurance	(1)									(1)	
Sales			25							25	
Cost of sales		(7)								(7)	
Creditors	(8)						(8)				
Utilities	(3)									(3)	
Employees	(5)									(5)	
Interest	(3)									(3)	
Dividends					2						(2)
Tax						3				(3)	
Transfer to RE										(3)	3
Ending Balance	8	5	25	10	2	3	3	30	15		(5)

Change in Cash = -\$20,000

Net Income = \$3,000



# ACCRUAL ACCOUNTING

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- **Cash accounting** is simple  
but does not reflect economic reality.
- **Accrual accounting** reflects economic reality  
but it may require managers' judgement.
- **Managerial judgement** in accounting may  
result in earnings manipulation.



# SUMMARY

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In this module, we:

- Learned how to code a business transaction in accounting language using “transaction worksheet”
- Used the transaction worksheet to prepare a balance sheet and income statement
- Critically compared accrual versus cash accounting

In the next module, we will cover the fundamental accounting concepts and revenue recognition.

