

Clearly, these employee journal sheets can get very lengthy very quickly. That's why many small businesses use computerized accounting systems to monitor both payroll and employee records. Figures 5-2 and 5-3 show you how a new employee is added to the QuickBooks system.

Figure 5-2:
New employee personal and contact information can be added in QuickBooks to make it easier to keep track of employees.

New Employee

Information for: _____

Change tabs: Personal Info

Personal | Address and Contact | Additional Info

Mr./Ms./... _____

Legal Name
First Name _____ M.I. _____
Last Name _____

Print on Checks as _____

SS No. _____

Gender: _____

Date of Birth: _____

OK
Cancel
Next
Help
 Employee is inactive

Order Business Cards

Figure 5-3:
QuickBooks enables you to track salary and deduction information, as well as information about sick time and vacation time.

Sick & Vacation for Laura Lake

Sick

Hours available as of 06/01/2005: 24:00
Hours used in 2005: 16:00

Accrual period: _____
Beginning of year: _____
Hours accrued at beginning of year: 0:00
Maximum number of hours: 80:00

Reset hours each new year?

Year begins on: January Day: 1

Begin accruing sick time on: 01/01/2005

Vacation

Hours available as of 06/01/2005: 0:00
Hours used in 2005: 40:00

Accrual period: _____
Beginning of year: _____
Hours accrued at beginning of year: 0:00
Maximum number of hours: 80:00

Reset hours each new year?

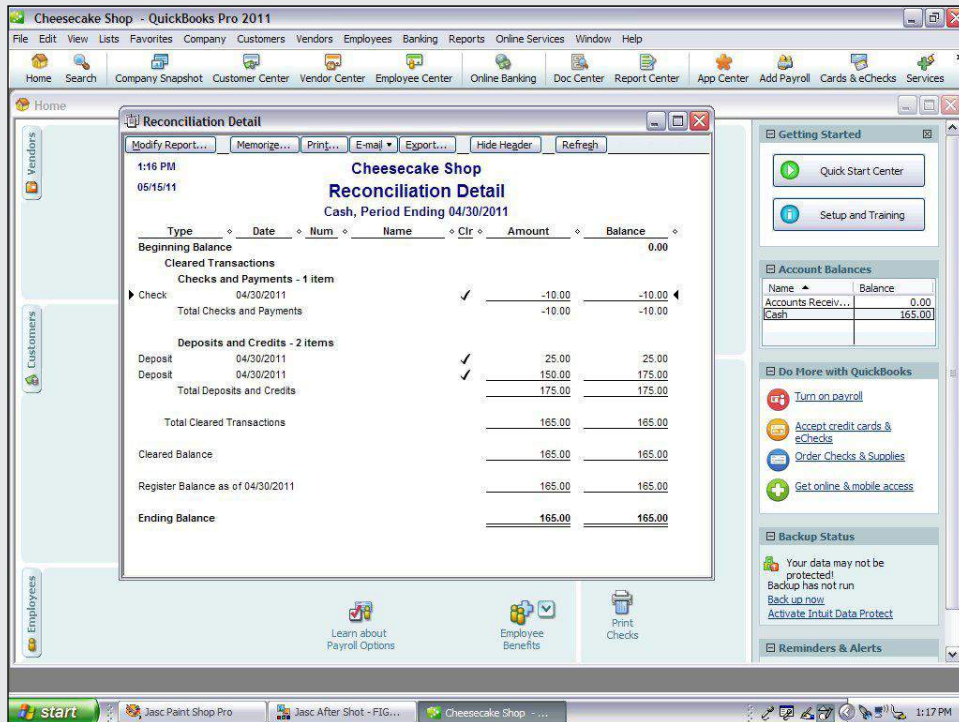
Year begins on: January Day: 1

Begin accruing vacation time on: 01/01/2005

OK
Cancel
Help

Book III

Adjusting and Closing Entries



Check out www.dummies.com/extras/accountingaio for specifics on how to adjust your accounting records with accruals and deferrals.

In this book...

- ✔ Choose the best depreciation method for your long-term assets. Assets are used to generate revenue, and depreciation expenses the cost of the asset as it's used in business.
- ✔ Account for interest your business pays or receives. If your business borrows or lends money, it pays or collects interest. Either way, you need to account for that interest.
- ✔ Prove out the cash to ensure that what's on paper matches the real dollar amounts in a store or office. Your cash account typically has a lot of transactions. As a result, you need to carefully account for cash to ensure that all the activity is properly recorded.
- ✔ Reconcile accounts and confirm that your journals and general ledger are correct. Reconciling your books is a great way to check your work, correct any errors, and even spot signs of fraud!
- ✔ Double-check your books by running a trial balance, correct any errors, and prepare a financial statement worksheet. A trial balance lists all your accounts and their dollar balances.
- ✔ Adjust the books in preparation of preparing financial reports. Trial balances are adjusted before being used to create financial statements to ensure accuracy in financial reports.

Chapter 1

Depreciating Your Assets

In This Chapter

- ▶ Understanding depreciation: What you do and why you do it
 - ▶ Exploring depreciation methods
 - ▶ Looking at depreciation's tax impact
-

All businesses have *fixed assets* — equipment, furnishings, and vehicles that last more than a year. Although they may last longer than other assets, even fixed assets eventually wear out or become obsolete and need replacing.

Of course, fixed assets, like other assets, are an expense, but because fixed assets last longer, you have options in how you account for those expenses. For example, you may choose to deduct the entire cost of a fixed asset the year you purchase it. Another option is to use a method called *depreciation* to write off the cost of the asset over several years or perhaps even over the life of that asset. Each option has its benefits and drawbacks.

This chapter introduces you to the various ways you can depreciate your assets and explains how to choose a depreciation method, calculate depreciation, and reap its tax benefits. Changes in the tax law may also impact your decisions about depreciation.

Defining Depreciation

Accountants use depreciation as a way to allocate the costs of a fixed asset over the period in which the asset is useable to the business. You, the accountant, normally record the full cost of the asset when the asset is purchased. Subtracting a portion of that value as a depreciation expense each year gradually reduces the value of the asset.

Depreciation expenses don't involve the exchange of cash; they're solely done for accounting purposes . . . and to reap tax benefits. Most companies enter depreciation expenses into the books once a year just before preparing their annual reports, but others calculate depreciation expenses monthly or quarterly.

One key reason to write off assets is to lower your tax bill, so the IRS gets involved in depreciation, too. As a business owner, you probably won't be able to write off the cost of all major purchases in one year. The IRS has strict rules about how you can write off assets as tax-deductible expenses. For more about the IRS's rules, see "Tackling Taxes and Depreciation," later in this chapter.

Knowing what you can and can't depreciate

Businesses don't depreciate all assets. Low-cost items or items that aren't expected to last more than one year are expensed immediately. In other words, these items aren't recorded as assets. For example, office supplies are expense items and not depreciated, but that office copier, which you'll use for more than one year, is recorded in the books as a fixed asset and depreciated each year over the course of its expected useful life.

Lifespan isn't the deciding factor for depreciation, however. Some assets that last many years are never depreciated. One good example is land; you can always make use of land, so its value never depreciates. You also can't depreciate any property that you lease or rent. If you make improvements to leased property, however, you can depreciate the cost of those improvements. In that case, you write off the lease or rent as an expense item and depreciate the lease improvements over their estimated useful life.



You can't depreciate any items that you use outside your business, such as your personal car or home computer. If you use these assets for both personal needs and business needs, you can depreciate a portion of them based on the percentage of time or other measurement that proves how much you use the car or computer for business.

For example, the portion of a car that can be depreciated can be based on the miles driven for business versus the miles driven for personal use. If you drive your car a total of 12,000 miles in a year and have records showing that 6,000 of those miles were for business purposes, you can depreciate 50 percent of the cost of the car. That percentage is allocated over the anticipated useful life of the car.

Another example of depreciation of a dual-usage asset is a room in your home designated exclusively for your business. You may be able to depreciate a portion of your home's cost as part of your business expenses. The amount you can depreciate is based on the portion of your home used for business.

Figuring out the useful life of a fixed asset

You're probably wondering how you figure out the useful life of a fixed asset. Well, the IRS has done the dirty work for you by creating a chart that spells out the recovery periods allowed for business equipment (see Table 1-1). Recovery periods are the anticipated useful lifespan of a fixed asset. For example, cars generally have a five-year recovery period because the IRS anticipates that they'll have a useful lifespan of five years. Although the car will probably run longer than that, you're not likely to continue using that car for business purposes after the first five years. You're more likely to trade it in and get a new car.

Table 1-1 Depreciation Recovery Periods for Business Equipment

<i>Property Class</i>	<i>Recovery Period</i>	<i>Business Equipment</i>
3-year property		Tractor units and horses over two years old
5-year property		Cars, taxis, buses, trucks, computers, office machines (faxes, copiers, calculators), research equipment, and cattle
7-year property		Office furniture and fixtures
10-year property		Water transportation equipment, single-purpose agricultural or horticultural structures
15-year property		Land improvements, such as shrubbery, fences, roads, and bridges
20-year property		Farm buildings that aren't agricultural or horticultural structures
27.5-year property		Residential rental property
39-year property		Nonresidential real estate, including a home office but not including the value of the land

Delving into cost basis

In order to calculate depreciation for an asset, you need to know the cost basis of that asset. *Cost basis* represents all the costs you incur to use the asset in your business. You use assets to make money — to make a product or service to sell. The equation for cost basis is:

$$\text{Cost of the fixed asset} + \text{Sales tax} + \text{Shipping and delivery costs} + \text{Installation charges} + \text{Other costs} = \text{Cost basis}$$

- ✔ **Cost of the fixed asset:** What you paid for the equipment, furniture, structure, vehicle, or other asset.
- ✔ **Sales tax:** What you were charged in sales tax to buy the fixed asset.
- ✔ **Shipping and delivery costs:** Any shipping or delivery charges you paid to get the fixed asset.
- ✔ **Installation charges:** Any charges you paid in order to have the equipment, furniture, or other fixed asset installed on your business's premises.
- ✔ **Other costs:** Any other charges you need to pay to make the fixed asset usable for your business. For example, if you buy a new computer and need to set up certain hardware in order to use that computer for your business, those setup costs can be added as part of the cost basis of the fixed asset (the computer). Training costs may also be part of your cost basis.

For additional details on how to determine which costs can be included in depreciation, see Book VIII, Chapter 1.

Evaluating Your Depreciation Options

For the purposes of this book, you may choose from among four methods of depreciation. Three are based on time: straight-line, declining balance, and sum-of-the-years'-digits. The fourth method, units-of-production, is based on actual physical usage of the fixed asset. Here's a brief explanation of each:

- ✔ **Straight-line method:** This method spreads out the cost of the fixed asset evenly over its useful life.
- ✔ **Declining balance method:** This is an *accelerated* method of depreciation, meaning the depreciation expense is higher in the earlier years of ownership.

- ✔ **Sum-of-the-years'-digits method:** This is another accelerated method of depreciation. With this method, you figure depreciation expense by assigning numbers (in declining order) to each year of the fixed asset's expected useful life. For example, an asset used for three years would require this calculation: $3 + 2 + 1 = 6$. Your depreciation rate for any given year is the year's assigned number divided by that sum, so the year 1 rate would be $3/6$ (or $1/2$).
- ✔ **Units-of-production method:** Using this method, you compare the total estimated number of units the fixed asset will produce over its expected useful life to the number of units produced in the current accounting period.



Depletion, which is the annual expense for the use of natural resources, is also based on actual physical usage. Examples of natural resources subject to depletion are oil, timber, and minerals.

Don't worry; the sections that follow walk you through a detailed example of each of the previously listed methods of depreciation. And to show how the choice of a depreciation method affects the amount of depreciation expense taken each year, each example uses the same asset facts and circumstances.

For the purposes of calculating depreciation in this chapter, here are the facts and circumstances for your sample fixed asset — a delivery van that the company buys on January 1, 2015:

- ✔ **The cost basis of the asset:** The earlier section “Delving into cost basis,” explains which costs to include in the *cost basis* — the total cost of the fixed asset. The cost base of the delivery van is \$30,000.
- ✔ **How long the company anticipates being able to use the fixed asset:** The company may measure the length in years, in production hours, or in miles driven. For this example, the business anticipates using the delivery van for 5 years or 50,000 miles.
- ✔ **The value of the asset after the company is done using it (known as its salvage value):** The *salvage value* is an estimate that management makes for how much the fixed asset will be worth when it's retired. When the delivery van is replaced, the company anticipates receiving \$3,000 in trade-in value. Cost basis less the salvage value equals depreciable base. Consider *depreciable base* to be the dollar amount you use to compute depreciation.
- ✔ **The depreciation method the company uses:** The method the business uses to depreciate should be appropriate for the asset. Accountants apply the *matching principle* to match revenue with the expense incurred to generate the revenue. For financial accounting, the standard of appropriateness is met if the company uses the method that most closely matches expenses to revenue.



A business can't arbitrarily switch methods after using one depreciation method for an asset. To do so would be a change in accounting method. If you do choose to change an accounting method, you need to justify the change (see Book I, Chapter 4 for more on selecting accounting methods).

- ✓ **Date of purchase and whether the company is on a calendar or fiscal year-end:** The date is when the fixed asset is ready for use. Calendar year-end is on December 31. A fiscal year ends on the last day of any other month of the company's choosing during the year. For example, a fiscal year can be April 1 through March 31. This business has a calendar year-end of December 31. The delivery van is purchased on January 1.

Ready? Well, start your engines and let's depreciate this delivery van!

Walking through the straight-line method

When using the straight-line method, the salvage value reduces the depreciable base. So the cost of the delivery van (\$30,000) less its salvage value (\$3,000) gives you a depreciable base of \$27,000.

The expected useful life is 5 years. So depreciation expense for the van is \$27,000/5 or \$5,400 depreciation expense per year for each of the 5 years. Book value at the end of year 5 is \$3,000.

Accelerating by using declining balance

To depreciate an asset more quickly during the earlier years of its use (than by using the straight-line method), you can use a declining balance method. Several declining-balance methods are available, but the double-declining balance method is used most often. It enables you to depreciate an asset at twice the rate of the straight-line method. The double-declining balance method is ideal for assets whose primary usefulness is in the early years of life.

To calculate depreciation by using the double-declining balance method, use this formula:

$$2 \times (1 \div \text{Estimated useful life}) \times \text{Book value at the beginning of the year} \\ = \text{Depreciation expense}$$



Note that double-declining balance calculates depreciation on *cost* (\$30,000), not *depreciable base* (\$27,000). Also, the straight-line method spreads depreciation evenly over 5 years, or 20 percent a year. Double-declining balance multiplies the cost by 40 percent — twice the 20 percent rate.

The calculation for the van's depreciation expense in the first year, using the declining balance method, is:

$$2 \times (1 \div 5) \times \$30,000 = \$12,000$$

At the beginning of the second year, you need to reduce the value of the asset by the year one depreciation amount; in this example, \$30,000 – \$12,000 = \$18,000. \$18,000 is your new book value. In other words, \$18,000 is the amount you plug into the formula to get year two depreciation. Plug that number into the formula, and you get:

$$2 \times (1 \div 5) \times \$18,000 = \$7,200$$

Perform the same calculation for the remaining years of useful life, and the five-year depreciation looks like this:

- ✔ **Year 1:** \$12,000
- ✔ **Year 2:** \$7,200
- ✔ **Year 3:** \$4,320
- ✔ **Year 4:** \$2,592
- ✔ **Year 5:** \$888

If you add the 5 years of depreciation in this example, the total is \$27,000. You've seen the number before: \$30,000 cost less \$3,000 salvage value. Your total depreciation using double-declining balance can't be more than cost less salvage value. When you reach salvage value, you sell the asset. So, depreciation stops at that point.

Figure 1-1 shows how to figure double-declining balance depreciation. Note that in year 5, the 40 percent depreciation rate doesn't matter because you have to limit the depreciation to salvage value. Because the ending net book value is \$3,888 in year 4, depreciation is limited to \$888 in year 5.

	Beginning Net Book Value	Rate	Depreciation Expense	Accumulated Depreciation	Ending Net Book Value
20X1	\$30,000	0.4	\$12,000	\$12,000	\$18,000
20X2	18,000	0.4	7,200	19,200	10,800
20X3	10,800	0.4	4,320	23,520	6,480
20X4	6,480	0.4	2,592	26,112	3,888
20X5	3,888	*	888	27,000	3,000

Figure 1-1:
A double-
declining
balance
depreciation
calculation.

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Calculating sum-of-the-years'-digits

Like all methods of depreciation, the sum-of-the-years'-digits method of depreciation bases the depreciation rate on the useful life of the asset, but with a twist. Using this method, you depreciate the asset by adding the useful life years together ($5 + 4 + 3 + 2 + 1 = 15$) to get the denominator for the rate fraction. The numerator is the number of years remaining in the depreciation schedule. In year one, your multiplier is $5/15$ ($1/3$); in year two, the multiplier is $4/15$; and so on. As with straight-line depreciation, you back out the salvage value before you start, so in this example, you start with $\$30,000 - \$3,000 = \$27,000$. The depreciation expense for the first year is:

$$\$27,000 \times 5/15 \text{ or } 1/3 = \$9,000$$

So here's how sum-of-the-years'-digits depreciation expense plays out for the delivery van over 5 years:

- ✔ **Year 1:** $\$27,000 \times 5/15 = \$9,000$ depreciation expense
- ✔ **Year 2:** $\$27,000 \times 4/15 = \$7,200$ depreciation expense
- ✔ **Year 3:** $\$27,000 \times 3/15 = \$5,400$ depreciation expense
- ✔ **Year 4:** $\$27,000 \times 2/15 = \$3,600$ depreciation expense
- ✔ **Year 5:** $\$27,000 \times 1/15 = \$1,800$ depreciation expense

Check the math: Adding up all five years of depreciation expense equals $\$27,000$, which is the cost of the delivery van less the salvage value!

Using the units-of-production method

The units of production (UOP) method of depreciation works well primarily in a manufacturing environment because it calculates depreciation based on the number of units produced in a year. Companies whose machinery usage varies greatly each year depending on the market and the number of units needed for sale make use of this depreciation method. Finally, this method helps you match an expense (depreciation expense) with revenue (sales of the items produced). The matching principle is mentioned earlier in this chapter.

The formula for calculating depreciation by using units of production is a two-step process:

1. Find the UOP rate by using this formula:

$$(\text{Cost} - \text{Salvage value}) \div \text{Estimated number of units to be produced during estimated useful life} = \text{UOP rate}$$

2. Find the depreciation expense by using this formula:

$$\text{Units produced during the year} \times \text{UOP rate} = \text{Depreciation expense}$$



You need to use the units-of-production depreciation method only if you're manufacturing the products you sell and the usage of your equipment fluctuates widely from year to year.

Here's how this method works with the delivery van purchase example: The business anticipates using the delivery van for 50,000 miles over the course of the 5 years when a depreciation expense is to be deducted. First, find the cost of the delivery van less salvage value: $\$30,000 - \$3,000 = \$27,000$. Divide this figure by your anticipated usage: $\$27,000/50,000$ miles equals $\$0.54$ per mile. If the van travels 8,000 miles in any given year, the depreciation expense for that year is:

$$8,000 \times \$0.54 = \$4,320$$

In essence, using this method for the delivery van is giving you a standard mileage rate. If you've ever done your own tax return and had to figure your mileage expense for charitable work you've done, it's the same concept.

Seeing how the methods compare

Just for fun, Figure 1-2 shows how the different depreciation methods result in a different amount of depreciation expense per year. Notice that over the entire 5-year useful life, total depreciation is $\$27,000$ regardless of the method

used. Thus, the different methods result in different depreciation expense amounts in each of the years but not in a difference in total depreciation over the life of the asset.

	Straight-line	Double Declining Balance	Sum-of-the-Years' Digits	* Units-of-Production
20X1	\$5,400	\$12,000	\$9,000	\$6,102
20X2	5,400	7,200	7,200	5,508
20X3	5,400	4,320	5,400	5,130
20X4	5,400	2,592	3,600	4,698
20X5	5,400	888	1,800	5,562
Total	27,000	27,000	27,000	27,000

* The number of miles the delivery van is driven is as follows:

20X1	11,300
20X2	10,200
20X3	9,500
20X4	8,700
20X5	11,100

Depreciation for year 5 is capped at \$5,562 because net book value can't be less than cost less salvage value.

Figure 1-2:
Comparison
of
depreciation
expense
among
methods.

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Pretty cool, huh?! Depending on the depreciation method the company uses for the fixed asset, depreciation expense can be all over the map. A business can use a different depreciation method for different types of assets as long as the depreciation method fairly shows the use of the asset over time.



More depreciation expense in an accounting period results in less net income, and vice versa.

Figuring partial year depreciation

The delivery van example was neat and clean because the company purchased the van on January 1 (the first day of its fiscal year). What happens if the company buys a fixed asset mid-year? How do you figure depreciation expense for a partial year?

Here's the solution: You prorate the depreciation expense among the accounting periods involved. For example, if the sample company buys a delivery van on June 1, the first year of depreciation is prorated by using the fraction 7/12 (because seven months remain in the fiscal year). Any leftover depreciation is taken in year 6.

Consider the delivery van while using the straight-line method. Depreciation expense in year 1 is now \$3,150 ($\$5,400 \times 7/12$). For years 2 through 5, the depreciation expense remains \$5,400. In year 6, you finish up by expensing the remaining \$2,250 ($\$5,400 \times 5/12$).



The journal entry (see Book I, Chapter 3) to book depreciation is to debit depreciation expense and credit accumulated depreciation.

Tackling Taxes and Depreciation

Depreciation calculations for tax purposes are a completely different animal from the calculations used to record depreciation for accounting purposes. You can use straight-line depreciation to calculate your depreciation expense for book (accounting record) purposes. Many businesses, however, use an accelerated method of depreciation for tax purposes. These companies prefer to write off the highest expense legally permissible and reduce their tax bills by the greatest amount as soon as possible.



Accountants reconcile differences between the accounting records (“book”) and the tax return (“tax”). You may hear accountants discussing book versus tax issues. One issue that causes these differences is the treatment of depreciation. The reconciliation process isn't discussed in this book, but you should keep this concept in mind.

In addition to straight-line depreciation, two other acceptable IRS methods for writing off assets are: Section 179 and Modified Accelerated Cost Recovery System (MACRS). The big advantage of the Section 179 Deduction is that you can write off up to 100 percent of the cost basis of qualifying property. If the property doesn't qualify under Section 179, many businesses choose to use MACRS rather than straight-line depreciation. (The following sections describe Section 179 and MACRS depreciation in greater detail.)

Section 179

Section 179, which gets its name from a section of the tax code, is a great boon for companies. Businesses can write off up to 100 percent of the full purchase price of the property.



The primary reason for this part of the tax code is to encourage businesses to buy new property in order to stimulate the economy. That's why only certain types of property are included, and the tax code limits the amount that can be deducted for some types of property.

Basically, Section 179's qualifying property includes tangible property such as machines, equipment, and furniture. In addition, some storage facilities qualify. Cars and SUVs between 6,000 and 14,000 pounds can be partially written off under Section 179.

You can get full details about Section 179 by ordering a copy of IRS Publication 946, *How to Depreciate Property*, from the IRS or accessing it online at www.irs.gov. If you're a business owner, work with your accountant to determine what's eligible and how much of the cost basis is eligible for the Section 179 deduction.

MACRS

The most common type of depreciation write-off used by businesses is Modified Accelerated Cost Recovery System, or MACRS. The recovery period shown in Table 1-1 is the basis for this depreciation method. After you know what type of property you have (three-year, five-year, and so on), you use the MACRS table in IRS Publication 946, *How to Depreciate Property*, to figure out the depreciation expense you can write off. If you're a business owner, you can leave MACRS calculations for your accountant to do when he prepares your business tax forms.

Chapter 2

Paying and Collecting Interest

In This Chapter

- ▶ Understanding interest calculations
 - ▶ Making the most of interest income
 - ▶ Calculating loan interest
-

Few businesses are able to make major purchases without taking out loans. Whether loans are for vehicles, buildings, or other business needs, businesses must pay *interest*, a percentage of the amount loaned, to their lenders.

Some businesses also loan money to borrowers and receive interest payments as income. In fact, a savings account can be considered a type of loan because by placing your money in the account, you're giving the bank the opportunity to loan that money to others. That interest is income for your company.

This chapter reviews different types of loans and how to calculate and record interest expenses for each type. It also explains how you calculate and record interest income in your business's books.

Deciphering Types of Interest

Any time you make use of someone else's money (whether that someone else is an individual or a bank), you have to pay interest for that use — whether you're buying a house, a car, or some other item you want. The same is true when someone else is using your money. For example, when you buy a corporate bond or deposit money in a money market account, you're paid interest for allowing someone to use your funds.

The financial institution that has your money will likely combine your money with that of other depositors and loan it to other people to make more interest than it's paying you. A corporation will use the proceeds from the bond issue to finance its business's expansion. The company wants to generate more in earnings than it will pay in interest expense.

Financial institutions use two types of interest calculations:

- ✓ **Simple interest** is calculated only on the principal amount of the loan.
- ✓ **Compound interest** is calculated on the principal and on the interest previously earned.

Simple interest

Simple interest is simple to calculate. Here's the formula for calculating simple interest:

$$\text{Principal} \times \text{Interest rate} \times n = \text{Interest}$$

The n in the equation stands for *number of periods*. To understand how interest is calculated, assume that someone deposited \$10,000 in the bank in a money market account earning 3 percent (0.03) interest for three years. So the interest earned over three years is $\$10,000 \times 0.03 \times 3 = \900 .

Compound interest

Compound interest is computed on both the principal and *any interest earned*. You must calculate the interest each year and add it to the balance before you can calculate the next year's interest payment, which will be based on both the principal and the interest earned.

Here's how you would calculate compound interest:

$$\begin{aligned} \text{Principal} \times \text{Interest rate} &= \text{Interest for year one} \\ (\text{Principal} + \text{Year one interest earned}) \times \text{Interest rate} &= \text{Interest for year two} \\ (\text{Principal} + \text{Years one and two interest earned}) \times \text{Interest rate} &= \text{Interest for year three} \end{aligned}$$

You repeat this calculation for all years of the deposit or loan. Compound interest assumes that interest payments are reinvested and earn additional interest. Compounding means that you're earning interest on a larger investment amount.

To understand how compounding interest impacts your earnings, notice how the amount of interest changes from one year to the next on a three-year deposit of \$10,000 at 3 percent (0.03):

$\$10,000 \times 0.03$	=	\$300.00 (Year one interest)
$(\$10,000 + 300) \times 0.03$	=	\$309.00 (Year two interest)
$(\$10,000 + 300 + 309) \times 0.03$	=	\$318.27 (Year three interest)
Total interest earned	=	\$927.27

You can see that you earn an extra \$27.27 during the first three years of the deposit if interest is compounded. When working with much larger sums or higher interest rates for longer periods of time, compound interest can make a big difference in how much you earn or how much you pay on a loan.



The *Rule of 72* is a tool you can use to remember how compound interest works. Seventy-two divided by the rate of compound interest gives you the number of years it will take for your money to double. For example, if the rate of compound interest is 6 percent, your money will double in $72 \div 6$, or 12 years. The higher the compound interest rate, the faster your money will double. At 12 percent, your money doubles in $72 \div 12$, or 6 years.



Ideally, you want to find a savings account, certificate of deposit, or other savings instrument that earns compound interest. But if you want to borrow money, look for a simple interest loan (see the previous section).

Also, not all accounts that earn compound interest are created equally. Watch carefully to see how frequently the interest is compounded. The preceding example assumes that interest is compounded annually. But if you can put your money into an account that compounds interest monthly, the interest you earn will be even higher.

Monthly compounding means that interest earned is calculated each month and added to the principal each month before calculating the next month's interest, which results in a lot more interest than a bank that compounds interest just once a year. Likewise, opt for loans that compound interest annually instead of quarterly or monthly.

Handling Interest Income

The income that your business earns from its savings accounts, certificates of deposits, or other investment vehicles is called *interest income*. As the bookkeeper, you're rarely required to calculate interest income by using the simple interest or compounded interest formulas described in the earlier sections of this chapter. In most cases, the financial institution sends you a monthly, quarterly, or annual statement that has a separate line item reporting interest earned.

When you get your monthly statement, you then reconcile the books — your accounting records. *Reconciliation* is a process in which you prove out whether your bank balance (on the bank statement) is equal to the cash balance in your accounting records. For more about reconciling bank accounts, see Chapter 4.

One step in the reconciliation process involves recording any bank activity that may not be posted to your books. Often, companies wait until they get the bank statement to post certain bank transactions. Two common transactions are interest earned and bank fees. You may post these entries after you receive the monthly bank statement.

If you're keeping the books manually, a journal entry to record interest income would look similar to this:

	<i>Debit</i>	<i>Credit</i>
Cash	\$100	
Interest income		\$100

To record interest income from American Savings Bank.

To record bank fees, you would debit (increase) an expense account and credit cash (a decrease). You pay bank fees in cash via your bank account.

When preparing financial statements, you show interest income on the income statement in a section called other income (see Book IV, Chapter 2 for more information about the income statement). Other income includes any income your business earned that wasn't directly related to your primary business activity — selling your goods or services.

Delving into Loans and Interest Expenses

Businesses borrow money for both *short-term periods* (less than 12 months) and *long-term periods* (more than 12 months). Short-term debt usually involves some form of credit card debt or line-of-credit debt. Long-term debt can include a five-year car loan, 20-year mortgage, or any other type of debt paid beyond one year.

Short-term debt

Any money due in the next 12-month period is shown on the balance sheet as short-term or current debt. Any interest paid on that money is shown as an interest expense on the income statement.



For the purposes of this book, a *current asset* represents cash or items that will be converted to cash within one year. *Current liabilities* will be paid in cash within one year.

In most cases, you don't have to calculate your interest due. The financial institution sending you a bill gives you a breakdown of the principal and interest to be paid.

Calculating credit card interest

When you get a credit card bill at home, a line always shows you new charges, the amount to pay in full to avoid all interest, and the amount of interest charged during the current period on any money not paid from the previous bill. If you don't pay your credit card in full, interest on most cards is calculated by using a daily periodic rate of interest, which is compounded each day based on the unpaid balance. When not paid in full, interest is calculated on the unpaid principal balance plus any unpaid interest. Table 2-1 shows what a typical interest calculation looks like on a credit card.

	Average Daily Balance	Daily Periodic Rate	Corresponding Annual Rate	Finance Charges	
				Daily Rate	Transaction Fees
Purchases	\$1,000	0.033973%	12.40%	\$0.34	\$50
Cash	\$200	0.045178%	16.49%	\$0.09	\$20

On many credit cards, you start paying interest on new purchases immediately, if you haven't paid your balance due in full the previous month. When opening a credit card account for your business, be sure you understand how interest is calculated and when the bank starts charging on new purchases. Some issuers give a grace period of 20 to 30 days before charging interest.



In Table 2-1, the finance charges include the daily rate charged in interest based on the daily periodic rate plus any transaction fees. For example, if you take a cash advance from your credit card, many credit card companies charge a transaction fee of 2 to 3 percent of the total amount of cash taken. This fee may also apply when you transfer balances from one credit card to another.

Although the company entices you with an introductory rate of 1 or 2 percent to get you to transfer the balance, be sure to read the fine print. You may have to pay a 3 percent transaction fee on the full amount transferred, which makes the introductory rate much higher.

Using credit lines

As a small-business owner, you generally get better interest rates by using a line of credit with a bank than with a credit card. Interest rates are usually lower on lines of credit. Typically, a business owner uses a credit card for purchases, but if he can't pay the bill in full, he draws money from his line of credit rather than carry over the credit card balance.

When the money is first received from the credit line, you record the cash receipt and the liability. Just to show you how this transaction works, here's a sample journal entry for the receipt of a credit line of \$1,500:

	<i>Debit</i>	<i>Credit</i>
Cash	\$1,500	
Credit line payable		\$1,500
<i>To record receipt of cash from credit line.</i>		

In this entry, you increase the cash account and the credit line payable account balances.

When you make your first payment, you must record the use of cash, the amount paid on the principal of the loan, and the amount paid in interest. Here is what that journal entry looks like:

	<i>Debit</i>	<i>Credit</i>
Credit line payable	\$150	
Interest expense	\$10	
Cash		\$160
<i>To make monthly payment on credit line.</i>		

This journal entry reduces the amount due in the credit line payable account, increases the amount paid in the interest expense account, and reduces the amount in the cash account.

If you're using a computerized system, you simply complete a check form and indicate which accounts are impacted by the payment. The system updates the accounts automatically.

When you prepare the check for printing in an automated system, you can add the accounts that are impacted by the payment. Your accounting system can then print the check and update all affected accounts. You don't need to do any additional postings to update your books.

Long-term debt

Most companies take on some form of *long-term debt* — debt to be paid over a period longer than 12 months. This debt may include car loans, mortgages, or promissory notes. A *promissory note* is a written agreement stating that you agree to repay someone a set amount of money at some point in the future at a particular interest rate. The term can be monthly, yearly, or some other period specified in the note. Most installment loans are types of promissory notes.

Recording a debt

When the company first takes on a long-term debt, it's recorded in the books in much the same way as a short-term debt:

	<i>Debit</i>	<i>Credit</i>
Cash	\$500	
Notes payable		\$500
<i>To record receipt of cash from American Bank promissory note.</i>		

Payments are also recorded in a manner similar to short-term debt:

	<i>Debit</i>	<i>Credit</i>
Notes payable	\$100	
Interest expense	\$5	
Cash		\$105
<i>To record payment on American Bank promissory note.</i>		

Although the way you enter the initial information isn't very different, a big difference exists between how short- and long-term debts appear on the financial statements. All short-term debt appears in the current liability section of the balance sheet.

Long-term debt is split and appears in different line items. The portion of the debt due in the next 12 months appears in the current liabilities section, which is usually a line item named something like “current portion of long-term debt.” The remaining balance of the long-term debt due beyond the next 12 months appears in the long-term liability section of the balance sheet as notes payable.

Considering major purchases and long-term debt

Sometimes a long-term liability is set up at the same time as you make a major purchase. You may pay some portion of the amount due in cash as a down payment and the remainder as a note. To see how to record such a transaction, assume that a business has purchased a truck for \$25,000, made a down payment of \$5,000, and signed a five-year (60 month) promissory note at an interest rate of 6 percent for \$20,000. Here's how you record this purchase in the books:

	<i>Debit</i>	<i>Credit</i>
Vehicles	\$25,000	
Cash		\$5,000
Notes payable – vehicles		\$20,000

To record payment for the purchase of the blue truck.

You then record payments on the note in the same way as you do on any other loan payment:

	<i>Debit</i>	<i>Credit</i>
Notes payable – vehicles	\$2,000	
Interest expense	\$300	
Cash		\$2,300

To record payment on the purchase of the blue truck.

Separating principal and interest

When recording the payment on a long-term debt for which you have a set installment payment, you may not get a breakdown of interest and principal with every payment. For example, when you take out a car loan, you may receive a coupon book with just the total payment due each month. Each payment includes both principal and interest, but you don't get any breakdown detailing how much goes toward interest and how much goes toward principal, which may change with each payment. (With many loans, you pay a greater portion of interest earlier in the term, so banks can collect their interest earlier, and a greater portion of the principal with later payments.)

In order to record long-term debt for which you don't receive a breakdown each month, you need to ask the bank that gave you the loan for an amortization schedule, create your own amortization schedule, or enter the details of the loan into your accounting program. An *amortization schedule* lists the total payment, the amount of each payment that goes toward interest, the amount that goes toward principal, and the remaining balance to be paid on the note.

Some banks provide an amortization schedule automatically when you sign all the paperwork for the note. If your bank can't give you one, you can easily generate one online by using an amortization calculator. BankRate.com has a good one at www.bankrate.com/brm/amortization-calculator.asp.

Using that calculator, an amortization schedule is generated for the entire 60-month term of the loan showing the principal and interest breakdown for each payment. Table 2-2 displays payment information for each of the first six months. As you can see, the amount paid to principal on a long-term note gradually increases, while the amount of interest paid gradually decreases as the note balance is paid off.

<i>Total Payment</i>	<i>Principal</i>	<i>Interest</i>	<i>Remaining Note Balance</i>
\$386.66	\$286.66	\$100.00	\$19,713.34
\$386.66	\$288.09	\$98.57	\$19,425.25
\$386.66	\$289.53	\$97.13	\$19,135.72
\$386.66	\$290.98	\$95.68	\$18,844.75
\$386.66	\$292.43	\$94.22	\$18,552.32
\$386.66	\$293.89	\$92.76	\$18,258.42

Looking at the six-month amortization chart, here is what you would need to record in the books for the first payment on the truck:

	<i>Debit</i>	<i>Credit</i>
Notes payable – vehicles	\$286.66	
Interest expense	\$100.00	
Cash		\$386.66

To record payment on note for blue truck.

In reading the amortization chart in Table 2-2, notice how the amount paid toward interest is slightly less each month as the balance on the note still due is gradually reduced. By the time you start making payments for the final year of the loan, interest costs drop dramatically because the principal balance is so much lower.



As you lower your principal balance, much less of your payment goes toward interest and much more goes toward reducing principal. That's why many financial specialists advise you to pay down principal as fast as possible if you want to reduce the term of a loan and, more importantly, the total amount you end up paying in interest.

Chapter 3

Proving Out the Cash

In This Chapter

- ▶ Understanding the purpose of closing out the cash
 - ▶ Counting your company's cash
 - ▶ Finalizing the cash journals
 - ▶ Using temporary posting journals
-

All business owners — whether the business is a small, family-owned candy store or a major international conglomerate — like to periodically verify how well their businesses are doing. They also want to be sure that the numbers in their accounting systems actually match what's physically in their stores and offices. After they check out what's in the books, these business owners can prepare financial reports to determine the company's financial success or failure during the last month, quarter, or year. This process of verifying the accuracy of your cash is called *proving out the cash*.

This chapter explains how to ensure the cash counts are accurate, finalize the cash journals for the accounting period, prove out the bank accounts, and post any adjustments or corrections to the general ledger.

Why Prove Out the Cash?

You're probably thinking that proving out the cash is a major, time-sucking endeavor. You're right — it's a big job, but it's also a very necessary one to do periodically so you can be sure that what's recorded in your accounting system realistically reflects what's actually going on in your business.

Any accounting system is susceptible to mistakes, and, unfortunately, any business can fall victim to incidents of theft or embezzlement. One way to minimize the risk is to periodically prove out the cash. The process of proving out the cash is a big part of the accounting cycle, discussed in detail in Book I, Chapter 1.

The first three steps of the accounting cycle — recording transactions, making journal entries, and posting summaries of those entries to the general ledger — involve tracking cash flow throughout the accounting period. All three steps are part of the process of recording a business's financial activities throughout the entire accounting period.

The rest of the steps in the accounting cycle are conducted at the end of the period and are part of the process of proving out the accuracy of your books. They include running a trial balance and creating a worksheet (see Chapter 5), adjusting journal entries (see Chapter 6), creating financial statements (see Books IV and V), and closing the books (see Chapter 4). Most businesses prove out their books every month.

Of course, you don't want to shut down your business for a week while you prove out the cash, so select a day during each accounting period on which you'll take a financial snapshot of the state of your accounts.



The balance sheet is always generated on a specific day to provide a snapshot in time. The income statement, on the other hand, displays your profit and loss for a period of time (month or year). If you try to generate a balance sheet for the month of June, you'll get an error message. Likewise, if you ask your system to produce an income statement for June 15, you'll get another error message.

If you're preparing monthly financial reports at the end of the month, you test the amount of cash your business has on hand as of that certain time and day, such as 6 p.m. on June 30 after your store closes for the day. The rest of the testing process — running a trial balance, creating a worksheet, adjusting journal entries, closing the books, and creating financial statements — is based on what happened *before* that point in time. When you open the store and sell more products the next day and buy new things to run your business, those transactions and any others that follow your test become part of the next accounting cycle.

Making Sure Ending Cash Is Right

Testing your books starts with counting your cash. Why start with cash? Because, for most businesses, the cash account has more transactions than any other account. More transactions in an account can mean a higher risk of error. Cash is also the asset most susceptible to theft.

If you prove your cash balance first, you're addressing your most difficult account first. Before you can even begin to test whether the books are right, you need to know whether your books have captured what's happened to

your company's cash and whether the amount of cash shown in your books actually matches the amount of cash you have on hand.



Accountants spend a lot of time looking at business transactions and considering which accounts are affected. When mulling over a transaction, ask yourself: Did anything happen to cash? Because cash is so often affected by business activity, this approach helps you post the activity to the right accounts.

Book II, Chapter 3 discusses how a business proves out the cash taken in by each of its cashiers. That process gives a business good control of the point at which cash comes in the door. The cashier accepts cash from customers who buy the company's products or services. Cashiers also process cash refunds given to customers who returned items. So, proving cash handled by cashiers is important. But the points of sale and return aren't the only times cash comes into or goes out of the business.

If your business sells products on store credit (see Book II, Chapter 3), you (or the bookkeeping staff responsible for tracking customer credit accounts) collect some of the cash from customers at a later point in time. And when your business needs something, whether products to sell or supplies for various departments, you must pay cash to vendors, suppliers, and contractors. Sometimes you pay cash on the spot, but many times you record the bill in the accounts payable account and pay it at a later date.

Your amount of cash on hand at any one time includes not only what's in the cash registers but also what's on deposit in the company's bank accounts. You need to know the balances of those accounts and test those balances to be sure they're accurate and match what's in your company's books.

Some departments may also have petty cash accounts, requiring that you total that cash as well. The total cash figure is what you report as an asset called "cash" on the first line of your company's *balance sheet*. The balance sheet shows all that the company owns (its assets) and owes (its liabilities) as well as the equity the owners have in the company. (To find out more about the balance sheet and how you prepare one, see Book IV, Chapters 3–5.)



The actual cash you have on hand is just one tiny piece of the cash moving through your business during the accounting period. The true detail of what cash has flowed into and out of the business is in your cash journals. Closing those journals is the next step in the process of figuring out how well your business is doing.

Closing the Cash Journals

As explained in Book I, Chapter 3, you can find a record of every transaction that involves cash in one of two cash journals: the cash receipts journal (cash that comes into the business) and the cash disbursements journal (cash that goes out of the business).

If you use a computerized accounting system, you have many additional ways to find the same information. You can run reports of sales by customer, item, or sales representative. You can also run reports that show you all the company's purchases by vendor or item as well as list any purchases still on order.



Cash receipts should be debited to increase cash. In the same way, cash disbursements are credited to reduce cash. If you identify all the cash receipts and disbursements, you should be able to match those transactions with the debits and credits.

A typical automated accounting system can generate purchase reports. You can run these reports by the week, month, quarter, or year. You can also customize the reports to show a particular period of time that you're analyzing. For example, if you want to know what purchases occurred between June 5 and 10, you can run a report specifying those exact dates. You have the same capability to generate sales reports.

In addition to the sales and purchase reports, you can generate other transaction detail reports, including customers and receivables; jobs, time, and mileage; vendors and payables; inventory; employees and payroll; and banking. One big advantage of a computerized accounting system when you're trying to prove out your cash is the number of different ways you can develop reports to check for accuracy in your books if you suspect an error.



Although the ability to generate tons of information is great, try to avoid information overload. Get training on your accounting system so you can quickly access the most meaningful and useful reports. Knowing how to generate the most useful reports quickly will save you time. Don't create ten sales reports if you use only two.

Finalizing cash receipts

If all your books are up-to-date, when you summarize the cash receipts journal to prove out your cash, you should come up with a total of all cash received by the business at that time. Up-to-date books ensure that all cash receipt transactions are posted to your accounting system.

Unfortunately, in the real world of bookkeeping, things don't always come out so nice and neat. In fact, you probably wouldn't even start entering the transactions from that particular day into the books until the next day, when you enter the cash reports from all cashiers and others who handle incoming cash (such as the accounts receivable staff who collect money from customers buying on credit) into the cash receipts journal.



After entering all the transactions from the day in question, the books for the period you're looking at may still be incomplete. Sometimes, adjustments or corrections must be made to the ending cash numbers. For example, monthly credit card fees and interest received from the bank may not yet be recorded in your cash journals.

As the bookkeeper or accountant, you must be sure that all bank fees are recorded to the cash disbursement journal. Interest earned is recorded in the cash receipts journal. After posting those entries, you can summarize the journals for the period you're analyzing.

Remembering credit card fees

When your company allows customers to use credit cards, you must pay fees to the bank that processes these transactions, which is probably the same bank that handles all your business accounts. These fees actually lower the amount you take in as cash receipts, so the amount you record as a cash receipt must be adjusted to reflect those costs of doing business. Monthly credit card fees vary greatly depending upon the bank you're using and other factors, but here are some of the most common fees your company should expect:

- ✔ **Address verification service (AVS) fee** is a fee companies pay if they want to avoid accepting fraudulent credit card sales. Businesses that use this service take orders by phone or e-mail and therefore don't have the credit card in hand to verify a customer's signature. Banks charge this fee for every transaction that's verified.
- ✔ **Chargeback and retrieval fees** are charged if a customer disputes a transaction and wins the dispute.
- ✔ **Customer support fees** are charged to companies that want bank support for credit card transactions 24 hours a day, 365 days a year. Companies such as mail-order catalogs that allow customers to place orders 24 hours a day look for this support. Sometimes companies even want this support in more than one language if they sell products internationally.
- ✔ **Discount rate** is a fee that all companies using credit cards must pay; it's based on a percentage of the sale or return transaction. The rate your company may be charged varies greatly depending on the type of

business you conduct and the volume of your monthly sales. Companies that use a terminal to swipe cards and electronically send transaction information usually pay lower fees than companies that use paper credit card transactions, because the electronic route creates less work for the bank and eliminates the possibility of key-entry errors by employees.

- ✓ **Equipment and software fees** are charged to your company if you lease credit card equipment and related software from the bank. You may have the option of buying the equipment and software for a one-time charge instead.
- ✓ **Monthly minimum fee** is the least amount a business is required to pay for the ability to offer its customers the convenience of using credit cards to buy products.
- ✓ **Secure payment gateway fee**, which allows the merchant to process transactions securely, is charged to companies that transact business over the Internet. If your business sells products online, you can expect to pay this fee based on a set monthly amount.
- ✓ **Transaction fee** is a standard fee charged to your business for each credit card transaction you submit for authorization. You pay this fee even if the cardholder is denied and you lose the sale.

Reconciling your credit card statements

Each month, the bank that handles your credit card sales will send you a statement listing

- ✓ All your company's transactions for the month.
- ✓ The total amount your company sold through credit card sales.
- ✓ The total fees charged to your account.

If you find a difference between what the bank reports was sold on credit cards and what the company's books show regarding credit card sales, it's time to play detective and find the reason for the difference. In most cases, the error involves the charging back of one or more sales because a customer successfully disputes the charge. In this case, the cash receipts journal is adjusted to reflect that loss of sale, and the bank statement and company books should match up.

For example, suppose \$200 in credit card sales were disputed. The original entry of the transaction in the books should look like this:

	<i>Debit</i>	<i>Credit</i>
Sales	\$200	
Cash		\$200

To reverse disputed credit card sales recorded in June.

This entry reduces the total sales for the month as well as the amount of the cash account. If the dispute is resolved and the money is later retrieved, the sale is then reentered when the cash is received.

You also record any fees related to credit card fees in the cash disbursements journal. For example, if credit card fees for the month of June total \$200, the entry in the books should look like this:

	<i>Debit</i>	<i>Credit</i>
Credit card fees	\$200	
Cash		\$200

To record credit-card fees paid for the month of June.

Summarizing the cash receipts journal

When you're sure that all cash receipts as well as any corrections or adjustments to those receipts have been properly entered in the books (see the previous two sections), you summarize the cash receipts journal as explained in detail in Book I, Chapter 3. After summarizing the cash receipts journal for the accounting period you're analyzing, you know the total cash that was taken into the business from sales as well as from other channels.

A customer who buys a product either pays at the time of purchase or on credit. So, in the cash receipts journal, sales usually appear in two columns:

- ✔ **Sales:** The cash shown in the sales column is cash received when the customer purchases the goods by using cash, check, or bank credit card.
- ✔ **Accounts receivable:** The accounts receivable column is for sales in which no cash was received when the customer purchased the item. Instead, the customer bought on credit and intends to pay cash at a later date. (For more about accounts receivable and collecting money from customers see Book II, Chapter 3.)

After you add all receipts to the cash receipts journal, entries for items bought on store credit can be posted to the accounts receivable journal and the individual customer accounts. You then send bills to customers that reflect all transactions from the month just closed as well as any payments still due from previous months. Billing customers is a key part of the closing process that occurs each month.

In addition to the sales and accounts receivable columns, your cash receipts journal should have at least two other columns:

- ✓ **General:** The general column lists all other cash received, such as owner investments in the business.
- ✓ **Cash:** The cash column contains the total of all cash received by the business during an accounting period.

Finalizing cash outlays

After you close the cash receipts journal (see “Summarizing the cash receipts journal”), the next step is to close the cash disbursements journal. Any adjustments related to outgoing cash receipts, such as bank credit card fees, should be added to the cash disbursements journal.

Before you close the journal, you must also be certain that any bills paid at the end of the month have been added to the cash disbursements journal.

Bills that are related to financial activity for the month being closed but that haven’t yet been paid have to be *accrued*, which means recorded in the books, so they can be matched to the revenue for the month. These accruals are necessary only if you use the accrual accounting method. If you use the cash-basis accounting method, you need to record the bills only when cash is actually paid. For more on the accrual and cash-basis methods, flip to Book I, Chapter 4.

You accrue bills yet to be paid in the accounts payable account. For example, suppose that your company prints and mails flyers to advertise a sale during the last week of the month. A bill for the flyers totaling \$500 hasn’t been paid yet. Here’s how you enter the bill in the books:

	<i>Debit</i>	<i>Credit</i>
Advertising	\$500	
Accounts payable		\$500
<i>To accrue the bill from Jack’s printing for June sales flyers.</i>		

This entry increases advertising expenses for the month and increases the amount due in accounts payable. When you pay the bill, the accounts payable account is debited (to reduce the liability), and the cash account is credited (to reduce the amount in the cash account). You make the actual entry in the cash disbursements journal when the cash is paid out.



When proving out the cash, also review any accounts in which expenses are accrued for later payment, such as sales tax collected, to be sure all accrual accounts are up-to-date. These tax accounts are actually liability accounts for taxes that will need to be paid in the future. If you use the accrual accounting method, the expenses related to these taxes must be matched to the revenues collected for the month they're incurred.

Using a Temporary Posting Journal

Some companies use a temporary posting journal to record payments that are made without full knowledge of how the cash outlay should be posted to the books and which accounts will be impacted. For example, a company using a payroll service probably has to give that service a certain amount of cash to cover payroll even if it's not yet known exactly how much is needed for taxes and other payroll-related costs.

In this payroll example, cash must be disbursed, but transactions can't be entered into all affected accounts until the payroll is done. Suppose a company's payroll is estimated to cost \$15,000 for the month of May. The company sends a check to cover that cost to the payroll service and posts the payment to the temporary posting journal.

After the payroll is calculated and completed, the company receives a statement of exactly how much was paid to employees and how much was paid in taxes. After the statement arrives, allocating the \$15,000 to specific accounts such as payroll expenses or tax expenses, that information is posted to the cash disbursements journal.



If you decide to keep a temporary posting journal to track cash coming in or going out, before summarizing your cash disbursements journal and closing the books for an accounting period, be sure to review the transactions listed in the temporary posting journal that may need to be posted in the cash disbursements journal.

Chapter 4

Reconciling Accounts and Closing Journal Entries

In This Chapter

- ▶ Reconciling accounts and making adjustments
 - ▶ Confirming that your journals are correct
 - ▶ Gathering journal information for closing
 - ▶ Posting adjustments to the general ledger
 - ▶ Examining your journals in a computerized system
-

As the old saying goes, “The devil is in the details.” When it comes to your bookkeeping, especially if you keep your books manually, those details are in the accounts and journals you keep. And any errors in those tiny details can lead to big problems down the road. To ensure accuracy, you must reconcile your accounts and prove out your journals and close them at the end of an accounting period, which is what this chapter is all about. Within these pages, you also find out how to post all corrections and adjustments to the general ledger after you make them in the appropriate journal. (To find out how to set up your journals, see Book I, Chapter 3.)

Reconciling Bank Accounts

Reconciling bank accounts involves verifying whether the cash balance in your accounting records agrees to the cash balance on your bank statement. Accountants use the phrase *balance per book* to refer to the cash balance in the accounting records. *Balance per bank* refers to your cash balance according to the bank statement.

Table 4-1 walks you through the bank reconciliation process. You've probably reconciled your personal checking account at least a few times over the years, and you'll be happy to hear that reconciling business accounts is a similar process that goes something like this:

- 1. Set up bank reconciliation template.** Set up a template with two columns. The bank statement column represents bank activity and the cash account column lists information from your accounting records. Post the beginning balances at the top. The bank balance is taken from the bank statement. The cash balance is the ending balance from your cash account.
- 2. Mark cleared transactions.** Compare the transactions in your cash accounting records with the bank statement and mark *cleared transactions* — transactions that appear both in the bank records and in your records. Because your book balance (accounting records) agrees with the bank statement, you don't need to do anything further with these transactions. Note, however, that you're not finished with the reconciliation process.
- 3. Note deposits in transit.** Deposits in your cash account that aren't listed in the bank statement are called *deposits in transit*. Post the total dollar amount as an addition to the bank column. In Table 4-1, deposits in transit total \$300.
- 4. Post outstanding checks.** Checks that aren't posted to the bank statement are considered *outstanding checks*. Post the total dollar amount as a subtraction from the bank column. In Table 4-1, outstanding checks total \$600.
- 5. Review the bank activity that isn't posted to the cash account.** Some transactions in your bank statement may not be posted to the cash account. In Table 4-1, \$20 in bank interest is added to the cash balance — because the interest isn't yet posted to the cash account. If you have bank fees, you subtract those fees from the cash account column.
- 6. Compare the bank and cash balances.** If you have properly reconciled, the bank balance should agree with the cash balance. In the table, both ending balances are \$720. Your cash account is reconciled with the bank statement. If the balances don't agree, you have more reconciling items to investigate.

Table 4-1 shows a common format for reconciling a bank account.

Table 4-1 includes three reconciling items (entries accounted for on the statement but not on the books or vice versa): outstanding checks, deposits in transit, and bank interest.

	<i>Bank Statement</i>	<i>Cash Account</i>
Starting balance	\$1,020	\$700
Deposits in transit (not shown on statement)	300	
Outstanding checks (not shown on statement)	(600)	
Interest (on statement but not posted to books)		20
Adjusted balance	720	720

Tracking down reconciling items

Often, your book balance and the bank statement balance don't agree. That's okay, because reconciling items are common. You just need to adjust for uncleared transactions. Here's a more complete list of reconciling items:

- ✔ **If the adjusted bank balance is higher than your balance**, check to be sure that all the deposits listed by the bank appear in the cash account in your books. If you find that the bank lists a deposit that you don't have, do some detective work to figure out what that deposit was for and add the detail to your accounting records. Also, make sure you've recorded all outstanding debits and added those amounts (as negative values) to the ending balance on the bank statement.
- ✔ **If the bank balance is lower than your balance**, check that all checks listed by the bank are recorded in your cash account. You may have missed one or two checks that were written but not properly recorded. You also may have missed a deposit that you have listed in your cash account but that the bank hasn't listed on the statement yet. If you notice a missing deposit on the bank statement, be sure you have your proof of deposit and confirm with the bank that the cash is in the account.
- ✔ **If all deposits and checks are correct but you still see a difference**, your only option is to make sure all checks and deposits were entered correctly (and not entered twice by mistake or for a different dollar amount) and check your calculations.

Using a computerized system

If you use a computerized accounting system, reconciliation should be much easier than if you keep your books manually. In QuickBooks, for example, when you start the reconciliation process, a screen pops up in which you can enter the ending bank statement balance and any bank fees or interest earned. Figure 4-1 shows you that screen.

Figure 4-1:
Displaying
the rec-
onciliation
process in
QuickBooks.

Begin Reconciliation

Select an account to reconcile, and then enter the ending balance from your account statement.

Account: Cash

Statement Date: 04/30/2011

Beginning Balance: 150.00 [What if my beginning balance doesn't match my statement?](#)

Ending Balance:

Enter any service charge or interest earned.

Service Charge	Date	Account
10.00	04/30/2011	Bank Service Charges
Interest Earned	Date	Account
25.00	04/30/2011	Interest Income

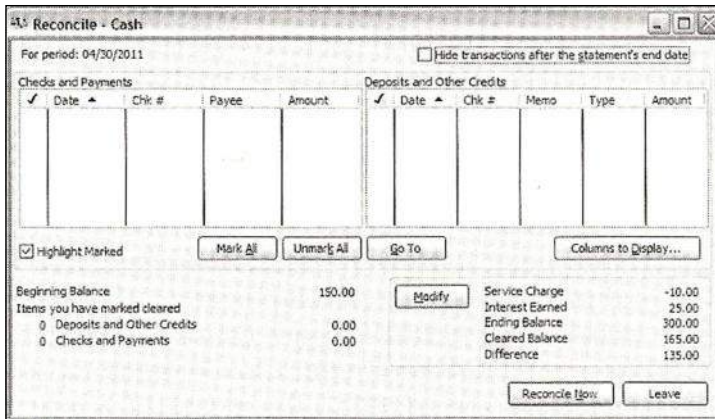
Buttons: Locate Discrepancies, Undo Last Reconciliation, Continue, Cancel, Help

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After you click Continue, you get a screen that lists all checks written since the last reconciliation as well as all deposits. You put a check mark next to the checks and deposits that have cleared on the bank statement, as shown in Figure 4-2, and then click Reconcile Now.

QuickBooks automatically reconciles the accounts and provides reports that indicate any differences. It also provides a *reconciliation summary*, shown in Figure 4-3, that includes the beginning balance, the balance after all cleared transactions have been recorded, and a list of all uncleared transactions. QuickBooks also calculates what your check register should show when the uncleared transactions are added to the cleared transactions.

Figure 4-2: To reconcile checking by using QuickBooks, you put a check mark next to all the checks and deposits that have cleared the account and click Reconcile Now.



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Figure 4-3: After reconciling your accounts, QuickBooks automatically provides a reconciliation summary.

Type	Date	Num	Name	Clr	Amount	Balance
Beginning Balance						0.00
Cleared Transactions						
Checks and Payments - 1 item						
Check	04/30/2011			✓	-10.00	-10.00
Total Checks and Payments					-10.00	-10.00
Deposits and Credits - 2 items						
Deposit	04/30/2011			✓	25.00	25.00
Deposit	04/30/2011			✓	150.00	175.00
Total Deposits and Credits					175.00	175.00
Total Cleared Transactions					165.00	165.00
Cleared Balance					165.00	165.00
Register Balance as of 04/30/2011					165.00	165.00
Ending Balance					165.00	165.00

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Posting Adjustments and Corrections

After you close out the cash receipts and cash disbursements journals and reconcile the bank account with your accounting system, you need to post any adjustments or corrections that you uncover to accounts that may be impacted by the change. For example, Table 4-1 lists a reconciling item of \$20 for bank interest. That interest isn't yet posted to your books. To post the item, debit (increase) cash \$20 and credit (increase) other income \$20.

If you find that several customer payments haven't been entered in the cash receipts journal, you need to post those payments to the cash receipts journal, the accounts receivable journal, and the customers' accounts. The same is true if you find payments on outstanding bills that haven't been entered into the books. In such cases, post the payments to the cash disbursements journal and the accounts payable journal as well as to the individual vendors' accounts.

Prepping to Close: Checking for Accuracy and Tallying Things Up

Closing the books is the process of finishing up all your accounting activity for the period (month or year). Said another way, closing the books ensures that your accounting records are ready to start the next accounting period. As you prepare to close the books, you first need to total what's in your journals, which is called *summarizing the journals*. During the process, it's a good idea to look for errors and be sure that the entries accurately reflect the business transactions during the accounting period.



Even the smallest error in a journal can cause a lot of frustration when you try to run a trial balance and close out your books, so it's best to do a thorough search for errors as you close out each journal for the month. Finding an error at this point in the closing process is much easier than trying to track it back through all your various accounts.

Paying attention to initial transaction details

Do a quick check to be sure the transaction details in your journals are accurate. The prior section explains how to do this type of check with the cash journals. When you follow the rules of accrual accounting, however, not all transactions involve cash. In accrual accounting, noncash transactions can include customer purchases made on store credit (which you track in the accounts receivable journal) and bills you will pay in the future (which you track in the accounts payable journal). You may also create other journals to track transactions in your most active accounts, and you probably also keep details about sales in the sales journal and payroll in the payroll journal.

In the payroll journal, make sure that all payroll for the month has been added with all the proper details about salaries, wages, and taxes. Also verify that you've recorded all employer taxes that need to be paid. These taxes include the employer's portion of Medicare and Social Security as well as unemployment taxes. (For more about payroll and payroll taxes, see Book II, Chapters 4 and 5.)

Summarizing journal entries

When you close your books at the end of the month, you summarize all the journals — that is, you total the columns and post the totals to the general ledger. Journals are temporary holding accounts for transactions. Eventually, all accounting activity must be posted to the general ledger. The general ledger, after all, is used to create financial statements.

Summarizing a journal is a four-step process:

- 1. Number each journal page at the top if it isn't already numbered.**
- 2. Total any column that's not titled general debit or general credit.** Any transactions recorded in the general debit or general credit columns need to be recorded individually in the general ledger.
- 3. Post the totals to the general ledger account.** Each transaction in the general credit or general debit column must be posted separately. Enter the date and journal page number as well as the amount of the debit or credit, so you can quickly find the entry for the original transaction if you need more details. Keep in mind that total debits in the general ledger should equal total credits.
- 4. In the post reference (PR) column of the journal, record information about where the entry is posted.** If the entry to be posted to the accounts is summarized and totaled at the bottom of the page, you can just put a check mark next to the entry in the PR column. For transactions listed in the general credit or general debit columns, you should indicate an account number for the account into which the transaction is posted. This process helps you confirm that you've posted all entries in the general ledger.

Figure 4-4 shows a summarized journal page, specifically the cash receipts journal. You can see that entries listed in the sales credit and cash debit columns on the cash receipts journal are just checked. Only one entry was placed in the general credit column, and that entry has an account number in the PR column. Although Figure 4-4 doesn't list all the transactions for the month, which would of course be a much longer list, it does show how you summarize the journal at the end of the month.

Cheesecake Shop						
Cash Receipts Journal						
March 2015						
Date	Account Credited	PR	General Credit	Accounts Receivable Credit	Sales Credit	Cash Debit
3/1	Sales	x			\$300	\$300
3/2	Sales	x			\$250	\$250
3/3	Ck. 121 from S. Smith	x		\$200		\$200
3/3	Sales	x			\$150	\$150
3/4	Owner Capital	3300	\$1,500			\$1,500
3/5	Ck 125 from J. Jones	x		\$100		\$100
3/5	Ck 567 from P. Perry	x		\$200		\$200
3/5	Sales	x			\$200	\$200
	March Summary		\$1,500	\$500	\$900	\$2,900

Figure 4-4:
Summary
of cash
receipts
journal
entries after
the first five
days.

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As you can see in Figure 4-4, after summarizing the cash receipts journal, there are only four general ledger accounts (general credit, accounts receivable credit, sales credit, and cash debit) and three customer accounts (S. Smith, J. Jones, and P. Perry) into which you need to post entries. Even better, the entries balance: \$2,900 in debits and \$2,900 in credits! To verify the credit total, add the totals at the bottom of each credit column.

The customer accounts total \$500, which is good news because it's the same amount credited to accounts receivable. The accounts receivable account is decreased (credited) by \$500 because payments were received, as is the amount due from the individual customer accounts.

Summarizing the accounts receivable journal gives you a grand total of all transactions for that period that involved customer credit accounts. Figure 4-5 shows a summary of an accounts receivable journal. The accounts receivable journal includes transactions from the sales journal (where customer purchases on store credit first appear) and the cash receipts journal (where customers' payments toward their store credit accounts first appear) as well as any credit memos for customer returns. The example in Figure 4-5 is only a few lines long, but, in most companies, the accounts receivable journal is very active with transactions posted every day the business is open during the month. When you summarize the accounts receivable journal, you get a *closing balance* that shows the total of all financial activity recorded in that journal. Figure 4-5 shows a closing balance of \$2,240, which is the amount outstanding from customers.

Figure 4-5:
A sample
accounts
receivable
journal
summary.

Cheesecake Shop					
Accounts Receivable					
March 2015					
Date	Description	Ref. #	Debit	Credit	Balance
	Opening Balance				\$2,000
3/31	From Cash Receipts Journal	Journal P2		\$500	\$1,500
3/31	From Sales Journal	Journal P3	\$800		\$2,300
3/31	Credit Memo 124 (General Journal)	Journal P3		\$60	\$2,240
	March Closing Balance				\$2,240

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Each transaction in the journal should have a reference number next to it, which tells you where the detail for that transaction first appears in the books. Each line item in Figure 4-5 has a journal page reference.

When you check for errors in the journal, you may need to review the original source information used to enter some transactions in order to double-check that entry's accuracy. In Chapter 3, you go over how to prove out cash, which includes a review for errors. In addition to the accounts receivable journal, you also have individual journal pages for each customer; these pages detail each customer's purchases on store credit and any payments made toward those purchases. At the end of an accounting period, accountants prepare an *aging summary* detailing all outstanding customer accounts. This report shows you what money is due from customers and how long it has been due. (See Book II, Chapter 3 for more about managing customer accounts.)

For the purpose of proving out the books, the aging report is a quick summary that ensures that the customer accounts information matches what's in the accounts receivable journal. Table 4-2 shows what an aging summary would look like as of March 31, 2015.

Table 4-2 **Aging Summary: Accounts Receivable**
as of March 31, 2015

Customer	Current	31–60 Days	61–90 Days	>90 Days
S. Smith	\$300			
J. Doe	100	\$300	\$200	
H. Harris	500	240		
M. Man	400	200		
Total	1,300	740	200	

In this sample accounts receivable aging summary, the total amount outstanding from customers matches the balance total in the accounts receivable journal (\$2,240) in Figure 4-5. To compute the total, add the total receivable amount in each column above ($\$1,300 + \$740 + \$200 = \$2,240$). Therefore, all customer accounts have been accurately entered in the books, and the bookkeeper shouldn't encounter any errors related to customer accounts when running a trial balance, as explained in Chapter 5.

If you find a difference between the information in your journal and your aging summary, review your customer account transactions to find the problem. An error may be the result of:

- ✓ Recording a customer purchase in the accounts receivable journal without recording the details of that transaction in the customer's account.
- ✓ Recording a customer purchase directly into the customer's account without adding the purchase amount to the accounts receivable journal.
- ✓ Recording a customer's payment in the customer's account without recording the cash receipt in the accounts receivable journal.
- ✓ Recording a customer's payment in the accounts receivable journal without recording the cash receipt in the customer's account record.

The process of summarizing and closing out the accounts payable journal is similar to that of the accounts receivable journal. For accounts payable, you can prepare an aging summary for your outstanding bills as well. That summary should look something like Table 4-3.

Table 4-3 **Aging Summary: Accounts Payable
as of March 31, 2015**

<i>Vendor</i>	<i>Current</i>	<i>31–60 Days</i>	<i>61–90 Days</i>	<i>>90 Days</i>
American Bank	\$150			
Carol's Realty	800			
Helen's Paper Goods		\$250		
Henry's Bakery Supplies		500		
Plates Unlimited	400	200		
Total	1,350	950		

The total of outstanding bills on the accounts payable aging summary should match the total shown on the accounts payable journal summary for the accounting period. If yours match, you're ready for a trial balance. If they don't, you must figure out the reason for the difference before closing out the accounts payable journal. Keep in mind that the vendor is the company that sold you the product or service on credit. The problem may be the result of:

- ✓ Recording a bill due in the accounts payable journal without recording it in the vendor's account.
- ✓ Recording a bill due in the vendor's account without recording it in the accounts payable journal.
- ✓ Making a payment to the vendor in the vendor's account without recording it in the accounts payable journal.
- ✓ Making a payment to the vendor and recording it in the accounts payable journal but neglecting to record it in the vendor's account.



Correct any problems you find before closing out the journal. If you know that you may be working with incorrect data, you don't want to try to do a trial balance. A trial balance with errors can't be used to generate accurate financial reports. Generating a trial balance without checking for errors is wasted effort.

Analyzing summary results

You may be wondering how you can find problems in your records by just reviewing a page in a journal. Well, that skill comes with experience and practice. As you summarize your journals each month, you'll become familiar with the expected level of transactions and the types of transaction that occur month after month. If you don't see a transaction that you expect to find, take the time to research the transaction to find out why it's missing. Perhaps the transaction didn't occur or someone forgot to record it.

For example, suppose that when summarizing the payroll journal, you notice that the payroll for the 15th of the month seems lower than normal. As you check your details for that payroll, you find that the amount paid to hourly employees was recorded, but someone didn't record the amount paid to salaried employees. For that particular payroll, the payroll company experienced a computer problem after running some checks and as a result sent the final report on two separate pages. The person who recorded the payroll numbers didn't realize there was a separate page for salaried employees, so the final numbers entered into the books didn't reflect the full amount paid to employees.



As you close the books each month, you'll get an idea of the numbers you can expect for each type of journal. After a while, you'll be able to pick out problems just by scanning a page — no detailed research required!

Planning for cash flow

The process you go through each month as you prepare to close your books helps you plan for future cash flow. Reviewing the accounts receivable and accounts payable aging summaries tells you what additional cash you can expect from customers during the next few months and how much cash you'll need in order to pay bills for the next few months.

If you notice that your accounts payable aging summary indicates that more and more bills are slipping into past-due status, you may need to find another source for cash, such as a credit line from the bank. For example, the accounts payable aging summary reveals that three key vendors — Helen's Paper Goods, Henry's Bakery Supplies, and Plates Unlimited — haven't been paid on time. Late payments can hurt your business's working relationship with vendors; they may refuse to deliver goods unless cash is paid upfront. And if you can't get the raw materials you need, you may have trouble filling customer orders on time. The lesson here is to act quickly and find a way to improve cash flow before your vendors cut you off. (For more on accounts payable management, check out Book II, Chapter 2.)

You may also find that your accounts receivable aging summary reveals that certain previously good customers are gradually becoming slow or nonpaying customers. For example, J. Doe's account is past due, and at least some portion of his account is overdue by more than 60 days. The bookkeeper dealing with these accounts may need to consider putting a hold on that account until payment is received in full. (For more on accounts receivable management, check out Book II, Chapter 3.)

Posting to the General Ledger

An important part of closing your books is posting to the general ledger any corrections or adjustments you find as you close the journals. This type of posting consists of a simple entry that summarizes any changes you found. For example, suppose you discover that a customer purchase was recorded directly in the customer's account record but not in the accounts receivable journal. You have to research how that transaction was originally recorded.

If the only record was a note in the customer's account, both the sales account and the accounts receivable account are affected by the mistake — both balances are understated. The correcting entry looks like this:

	<i>Debit</i>	<i>Credit</i>
Accounts receivable	\$100	
Sales		\$100
<i>To record sale to J. Doe on 3/15/2015 — corrected 3/31/2015.</i>		



If you find this type of error, the sales transaction record for that date of sale isn't accurate, which means that someone bypassed your standard bookkeeping process when recording the sale. You may want to research that part of the issue as well because there may be more than just a recording problem behind this incident. Someone in your company may be allowing customers to take product, purposefully not recording the sale appropriately in your books, and pocketing the money instead. It's also possible that a salesperson recorded a sale for a customer that never took place. If that's the case and you bill the customer, he would likely question the bill, and you'd find out about the problem at that point.



The process of proving out your journals, or any other part of your bookkeeping records, is a good opportunity to review your internal controls as well. As you find errors during the process of proving out the books, keep an eye out for exceptions (probably similar errors that appear frequently) that may indicate bigger problems than just bookkeeping mistakes.

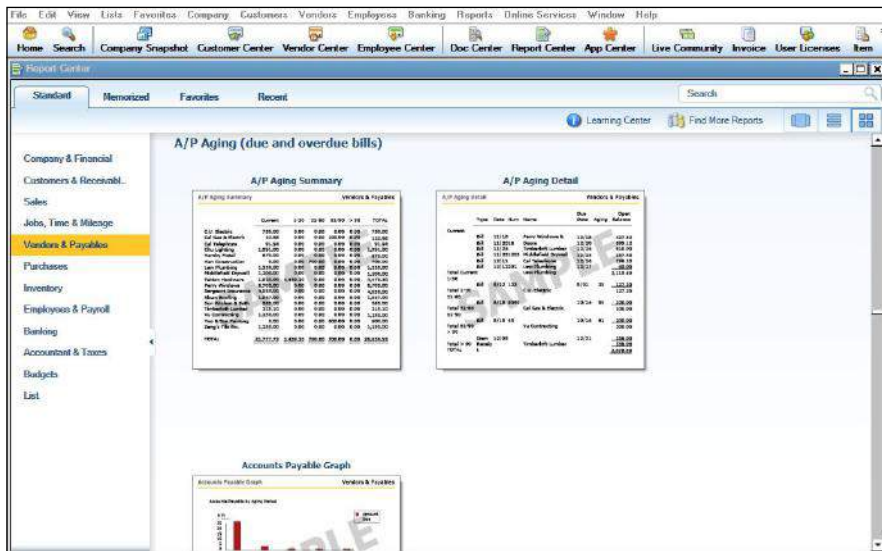
Repeat errors may call for additional staff training to be sure your bookkeeping rules are being followed to a T. Unfortunately, such errors may be evidence that someone in the company is deliberately recording false information. Whatever the explanation, you need to take corrective action. (See Book IX, Chapter 2 for coverage of internal controls.)

Checking Out Computerized Journal Records

Although you don't have to close out journal pages if you keep your books by using a computerized accounting system, running a spot-check (at the very least) of what you have in your paper records versus what you have on your computer is a smart move. Simply run a series of reports by using your computerized accounting system and then check to be sure that those computer records match what you have in your files.

For example, in QuickBooks, go to the Report Navigator and click on Vendors & Payables. The first section of the navigator page, shown in Figure 4-6, is called A/P Aging (due and overdue bills). This section offers three possible reports: Summary, which shows how much is due for each vendor; Detail, which gives a list of bills due and overdue; and an Accounts Payable Graph that illustrates your outstanding bills.

Figure 4-6: QuickBooks allows you to run a number of reports concerning vendors and payables. Essentially, these reports tell you how much money your company owes to others.



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Figure 4-7 shows you the kind of detail you get when you select the Detail report. The Detail report is divided into:

- Current bills
- Bills overdue by 1 to 30 days
- Bills overdue by 31 to 60 days
- Bills overdue by 61 to 90 days
- Bills overdue by more than 90 days



Obviously, anything in the last two sections — overdue by more than 60 days — is bad news. You can expect a supplier or vendor whose bills appear in these columns to soon cut you off from additional credit until your account is up-to-date.

Figure 4-7:
When you run an Accounts Payable Detail report in QuickBooks, you get a listing of all outstanding bills, the dates the bills were received, and the dates they're due.

Type	Date	Num	Name	Due Date	Aging	Open Balance
Bill	12/02/2015		Dagle Lighting	01/01/2017		52.00
Bill	12/04/2015		Perry Windows & ...	01/03/2017		2,400.00
Bill	12/06/2015		Timberloft Lumber	01/05/2017		115.00
Bill	12/11/2015		Perry Windows & ...	01/10/2017		130.00
Bill	12/11/2015		Hamlin Metal	01/10/2017		670.00
Bill	12/12/2015		Washuta & Son Pa...	01/11/2017		600.00
Bill	12/12/2015		Patton Hardware S...	01/11/2017		810.00
Bill	12/12/2015		C.U. Electric	01/11/2017		250.00
Bill	12/12/2015		Sloan Roofing	01/11/2017		1,047.00
Bill	12/15/2015		Sergeant Insurance	01/14/2017		4,050.00
Bill	12/15/2015	8059	Thomas Kitchen & ...	01/14/2017		585.00
Total Current						23,177.72
1 - 30						
Item Receipt	12/05/2015		Patton Hardware S...			3,459.20
Total 1 - 30						3,459.20
31 - 60						
Total 31 - 60						
61 - 90						
Total 61 - 90						
> 90						
Total > 90						
TOTAL						26,636.92

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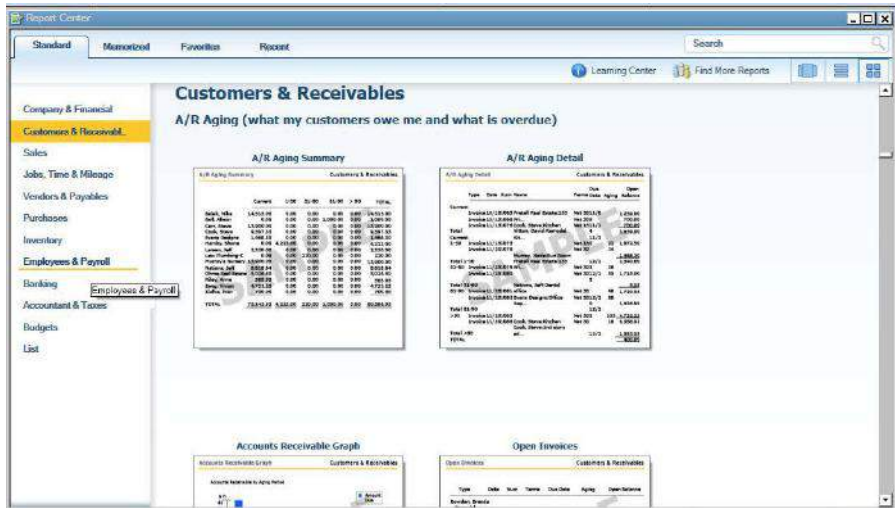
In addition to locating your bill-paying problem areas, you can also use the information in the Detail report to verify that the paper bills you have waiting to be paid in vendor files match what you have on your computer. You don't need to check every bill, but doing a spot-check of several bills is good practice. The goal is to verify the accuracy of your records as well as make sure that no one's entering and paying duplicate or nonexistent bills.



When it comes to cash flow out of the business, keep tight controls on who can actually sign checks and how the information that explains those checks is recorded. See Book II, Chapter 2 for more about the importance of separating duties to protect each aspect of your bookkeeping system from corruption.

You can also run reports showing the information recorded in your accounts receivable account. Figure 4-8 shows you a list of possible reports to run from the Customers & Receivables page. In addition to the Summary, Detail, and Accounts Receivable Graph, you can also run a report for Open Invoices, which lists outstanding customer invoices or statements, and Collections, which lists not only overdue customers but also how much they owe and their contact information.

Figure 4-8:
In QuickBooks, you can run a series of reports that summarize customer accounts.



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Again, running spot-checks on a few customer accounts to be sure your paper records of their accounts match the information in your computerized system is a good idea. There's always a chance that a customer's purchase was entered in error in the computer, and you could end up sending the bill to the wrong person.



Some companies double-check their accounts receivable bookkeeping for accuracy by sending surveys to customers periodically (usually twice a year) to see whether their accounts are correct. If you choose to do this, include with the customer's bill a postage-paid card asking whether the account is correct and giving the customer room to indicate any account problems before mailing the card back to your company. You can also send a survey by e-mail. In most cases, a customer who has been incorrectly billed will contact you soon after getting that bill — especially if he or she has been billed for more than anticipated.

In addition to keeping actual accounts, such as accounts payable or accounts receivable, your computerized accounting system keeps a journal of all your company's transactions. This journal contains details about all your transactions over a specified time period and the accounts that were impacted by each transaction. Figure 4-9 is a sample computerized journal page.

Figure 4-9:
A computerized accounting system keeps a journal of all transactions, which you can review during the closing process.

Trans #	Type	Date	Num	Name	Memo	Account	Debit	Credit
184	Check	12/01/2015	476	Abercrombie, Kris...		10100 - Checking		711.15
				Abercrombie, Kris...		11000 - Accounts...	711.15	
							711.15	711.15
185	Credit Memo	12/01/2015	4002	Abercrombie, Kris...		11000 - Accounts...		711.15
				Abercrombie, Kris...	Whitpool tub...	40140 - Materials L...	660.00	
				State Board of Equ...	CA sales tax...	25500 - Sales Tax...	51.15	
							711.15	711.15
248	Bill	12/01/2015		Fay, Maureen Lyn...		20000 - Accounts...		250.00
				Overhead	Pre-tax work	63610 - Accounting	250.00	
							250.00	250.00
253	Bill Pmt - Check	12/01/2015	477	Larson Flooring		10100 - Checking		2,700.00
				Larson Flooring		20000 - Accounts...	2,700.00	
							2,700.00	2,700.00
254	Check	12/01/2015	478	Gregg O. Schneider	Reimbusem...	10100 - Checking		62.00
				Gregg O. Schneider	Reimbusem...	12800 - Employee ...	62.00	
							62.00	62.00
257	Payment	12/03/2015		Teschner, Anton S...		10100 - Checking	1,200.00	
				Teschner, Anton S...		11000 - Accounts...		1,200.00
							1,200.00	1,200.00
260	Bill	12/05/2015		Hopkins Construct...		20000 - Accounts...		550.00
				Melton, Johnny De...	Equipment R...	54200 - Equipment...	550.00	
							550.00	550.00

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If you need to be reminded of how you recorded a transaction into your computerized accounting system, run the journal report by date, isolating all transactions that took place at a particular time. Running a report by date can be a helpful tool if you're trying to locate the source of an error in your books; if you find a questionable transaction, you can open the detail of that transaction and see how it was entered and where you can find the original source material.

Chapter 5

Checking Your Accuracy

In This Chapter

- ▶ Checking your math with a trial balance
 - ▶ Finding and correcting errors
 - ▶ Preparing a worksheet
 - ▶ Generating reports from your computerized system
-

After you close all your journals and do your best to catch any and all errors (flip to Chapter 4 for instructions on how to do this), the time comes to test your work. If you've entered all double-entry transactions into the books correctly, the books balance out, and your trial's a success!

Unfortunately, few bookkeepers get their books to balance on the first try. And in some cases, the books balance, but errors still exist. This chapter explains how you do a trial balance of your books and gives tips on finding any errors that may be lurking. You also find out how to take your first step toward developing financial reports (see Books IV and V) by creating a worksheet.

Working with a Trial Balance

When you first start entering transactions in a dual-entry accounting system, you may think, "This is a lot of work, and I don't know how I'm ever going to use all this information." You enter all your transactions, using debits and credits, without knowing whether they'll actually produce useful financial information that you can use to gauge how well your business is doing. It's not until after you close your journals and prepare your first set of financial reports that you truly see the value of double-entry accounting.

The first step toward producing useable reports that help you interpret your financial results is doing a *trial balance* — a worksheet prepared manually or spit out by your computer accounting system that lists all the accounts in your general ledger and each account balance at the end of an accounting period.



The purpose of the trial balance is to prove that, at least mathematically, your debits and credits are equal. If any errors exist in your calculations or in the way you summarized the journals or posted the summaries to the general ledger, they're uncovered in the trial balance when total debits and total credits don't come out equal.

Conducting your trial balance

If you've entered transactions manually, you create a trial balance by listing all the accounts with their ending debit or credit balances. (See Book I, Chapter 2 for more about debits and credits.) After preparing the list, you total both the debit and credit columns. If the totals at the bottom of the two columns are the same, the trial is a success, and your books are in balance. Following are step-by-step instructions for developing a trial balance:

- 1. Prepare a worksheet with three columns: one for account titles, one for debits, and one for credits.**
- 2. Fill in all the account titles and record their balances in the appropriate debit or credit columns.**
- 3. Total the dollar amounts in the debit column and write the total at the bottom of the column.**
- 4. Total the dollar amounts in the credit column and write the total at the bottom of the column.**
- 5. Compare the debit and credit column totals.**

Figure 5-1 shows a sample trial balance for a company as of May 31, 2014. Note that the debit column and the credit column both equal \$57,850, making this a successful trial balance.



A successful trial balance is no guarantee that your books are free of errors; it just means that all your transactions have been entered in balance. The books may still contain errors related to how you entered your transactions, including:

- ✓ You forgot to put a transaction in a journal or in the general ledger.
- ✓ You forgot to post a journal entry to the general ledger.
- ✓ You posted a journal entry twice in either the general ledger or in the journal.
- ✓ You posted the wrong amount.
- ✓ You posted a transaction to the wrong account.
- ✓ Your account doesn't display a normal balance, as explained in the next section.

Account	Debit	Credit
Cash	\$2,500.00	
Petty Cash	\$500.00	
Accounts Receivable	\$1,000.00	
Inventory	\$1,200.00	
Equipment	\$5,050.00	
Vehicle	\$25,000.00	
Furniture	\$5,600.00	
Accounts Payable		\$2,200.00
Loans Payable		\$29,150.00
Capital		\$5,000.00
Sales		\$20,000.00
Sales Discounts	\$1,000.00	
Purchases	\$8,000.00	
Purchase Discounts		\$1,500.00
Credit Card Fees	\$125.00	
Advertising	\$1,500.00	
Bank Service Charges	\$120.00	
Insurance Expenses	\$100.00	
Interest Expense	\$125.00	
Legal and Accounting Expense	\$300.00	
Office Expense	\$250.00	
Payroll Taxes Expense	\$350.00	
Postage Expense	\$75.00	
Rent Expense	\$800.00	
Salaries & Wages Expense	\$3,500.00	
Supplies	\$300.00	
Telephone Expenses	\$200.00	
Utilities Expenses	\$255.00	
Totals	\$57,850.00	\$57,850.00

Figure 5-1:
A sample
trial
balance.

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Understanding normal balances for your accounts

Every account should consistently display either a debit or credit balance, depending on the type of account. Accountants refer to these balances as *normal balances*. Asset accounts normally display debit balances. Cash, an asset account, should have a debit balance at any point in time. Expense accounts in the income statement also have a normal debit balance.

Liability and equity accounts have normal credit balances. Accounts payable, a liability account, should have a credit balance. Revenue (or sales) in the income statement also has a normal credit balance.

During your trial balance review, if you notice an account that doesn't have a normal balance, that could be the sign of an error. You should consider making a journal entry to adjust the account. Every account should have a normal balance, or a balance of zero.

Adjusting an account to properly reflect a normal balance

Assume that you compile your trial balance and notice that your ending balance in cash is a credit balance of \$100. A normal balance for cash, an asset account, is a debit balance. The credit balance in cash is a *negative balance*. If you have a negative balance in the bank, that means the bank has given you a loan. The negative amount (or overdraft) must be paid back to the bank.

As mentioned in the previous section, you need to post a journal entry to adjust the cash balance to zero. In this case, you would debit cash \$100 and credit loans payable (a liability account) \$100. Your cash balance is now zero, and you have properly set up a loan balance for the amount you owe the bank.



If, by chance, the errors listed here slip through the cracks, there's a good chance that the discrepancy will become evident in the financial reports.

Dealing with trial balance errors

If your trial balance isn't correct, you need to work backward in your closing process to find the source of the mathematical error. And remember, bookkeepers and accountants work with pencils instead of pens for this reason — pencils make correcting errors much easier. When you need to find errors after completing a trial balance that fails, follow these four basic steps to identify and fix the problem:

- 1. Check your math.** Keep your fingers crossed and total the debits and credits in your trial balance again to be sure the error isn't just one of addition. That's the simplest kind of error to find. Correct the addition mistake and re-total your columns.
- 2. Compare your balances.** Double-check the balances on the trial balance worksheet by comparing them to the totals from your journals and your general ledger. Be sure you didn't make an error when transferring the account balances to the trial balance. Correcting this type of problem isn't very difficult or time-consuming. Simply correct the incorrect balances, and total the debits and credits in your trial balance again.

3. **Check your journal summaries.** Double-check the math in all your journal summaries, making sure that all totals are correct and that any totals you posted to the general ledger are correct. Running this kind of a check, of course, is somewhat time-consuming, but it's still better than rechecking all your transactions. If you do find errors in your journal summaries, correct them, reenter the totals correctly, change the numbers on the trial balance worksheet to match your corrected totals, and retest your trial balance.
4. **Check your journal and general ledger entries.** Unfortunately, if Steps 1, 2, and 3 fail to fix your problem, all that's left is to go back and check your actual transaction entries. The process can be time-consuming, but the information in your books isn't useful until your debits equal your credits.



If Step 4 is your last resort, scan through your entries looking specifically for ones that appear questionable. For example, if you see an entry for office supplies that's much larger or much smaller than usual, check the original source material for that entry to be sure it's correct. If you carefully proved out the accounts payable and accounts receivable journals as explained in Chapters 3 and 4, you can concentrate your efforts on accounts with separate journals. After you find and correct the error(s), run another trial balance. If total debits and total credits still don't match up, repeat the steps listed here until your debits and credits equal out.



You can always go back and correct the books and do another trial balance before you prepare the financial reports. Don't close the books for the accounting period until the financial reports are completed and accepted. See Books IV and V for more about preparing financial reports.

Testing Your Balance by Using Computerized Accounting Systems

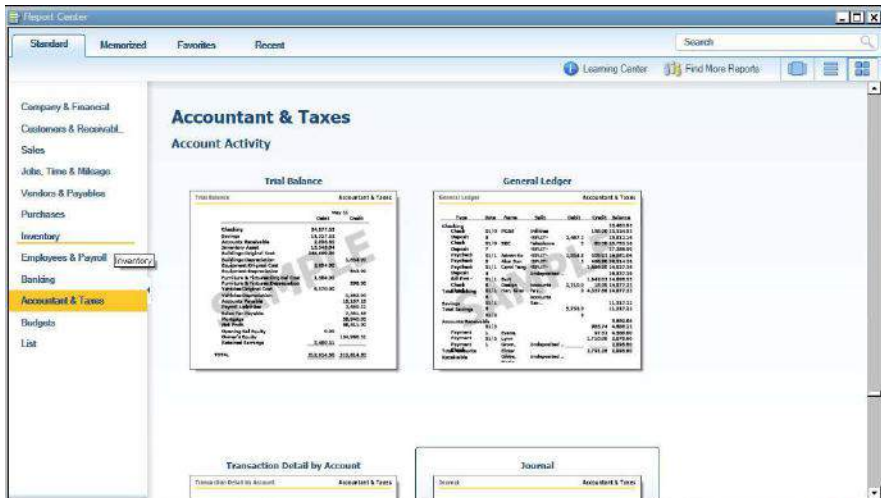
If you use a computerized accounting system, it automatically generates your trial balance for you. Because the system enables you to enter only transactions that are in balance, the likelihood that your trial balance won't be successful is pretty slim. But that doesn't mean your accounts are guaranteed error-free.

Remember the saying, “Garbage in, garbage out?” If you make a mistake when you enter transaction data into the system, even if the data’s in balance, the information that comes out will also be in error. Although you don’t have to go through the correction steps covered in the earlier section “Dealing with trial balance errors” to reach a successful trial balance, you still may have errors lurking in your data.

Accountants frequently run an automated trial balance report at the end of every period. You’ll get in the habit of reviewing the trial balance, making corrections, and running a new trial balance. In addition to the trial balance, automated systems can generate a report showing the general ledger, transaction detail by account, journal detail, voided transactions, and transactions by date. In QuickBooks, you can assess the Accountant & Taxes page, as shown in Figure 5-2, to find these reports.

A business’s accountant is likely to use many of the report options to double-check that transactions were entered correctly and that no one is playing with the numbers. In particular, the accountant may use a report option called *Audit Trail*, which reveals what changes impacted the company’s books during an accounting period and who made those changes. This type of report is available in most automated accounting systems.

Figure 5-2:
The Accountant & Taxes page of QuickBooks’s Report Navigator provides the option of creating many useful reports.



Intuit.com

Although it doesn’t match the trial balance done manually in Figure 5-1, the QuickBooks trial balance shown in Figure 5-3 gives you an idea of what a computerized accounting trial balance looks like.

	Nov 30, 15	
	Debit	Credit
10100 - Checking	55,641.39	
10300 - Savings	43,410.19	
10400 - Petty Cash	500.00	
11000 - Accounts Receivable	83,547.91	
12000 - Undeposited Funds	0.00	
12100 - Inventory Asset	27,872.63	
12800 - Employee Advances	770.00	
13100 - Pre-paid Insurance	0.00	
13400 - Retainage Receivable	5,418.02	
15000 - Furniture and Equipment	34,326.00	
15100 - Vehicles	78,936.91	
15200 - Buildings and Improvements	325,000.00	
15300 - Construction Equipment	15,300.00	
16800 - Land	90,000.00	
17000 - Accumulated Depreciation		110,344.80
18700 - Security Deposits	1,720.00	
20000 - Accounts Payable		58,345.02
20500 - QuickBooks Credit Card		25.00
20600 - CalOil Credit Card		436.80
24000 - Payroll Liabilities:24010 - Federal Withholding		841.00
24000 - Payroll Liabilities:24020 - FICA Payable		1,293.78
24000 - Payroll Liabilities:24030 - AEIC Payable	0.00	
24000 - Payroll Liabilities:24040 - FUTA Payable	0.00	
24000 - Payroll Liabilities:24050 - State Withholding		191.21
24000 - Payroll Liabilities:24060 - SUTA Payable	0.00	
24000 - Payroll Liabilities:24070 - State Disability Payable		82.57
24000 - Payroll Liabilities:24080 - Worker's Compensation		805.83

Figure 5-3:
A sample
trial balance
report
produced by
QuickBooks.

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Developing a Financial Statement Worksheet

After your accounts successfully pass a trial balance test (see “Conducting your trial balance” earlier in this chapter), you can take your first stab at creating *financial statements*, including a balance sheet and an income statement. The first step in producing these statements is using the information from the trial balance and its corrections to develop a *worksheet* that includes the initial trial balance, the accounts that would normally appear on a balance sheet, and the accounts that would normally appear on an income statement.

You create the worksheet that includes these seven columns:

- ✓ **Column 1:** Account list
- ✓ **Columns 2 and 3:** Trial balance (one column for debits, one column for credits)
- ✓ **Columns 4 and 5:** Balance sheet (one column for debits, one column for credits)
- ✓ **Columns 6 and 7:** Income statement (one column for debits, one column for credits)

Figure 5-4 shows a sample of a worksheet developed from trial balance numbers. Note that the numbers of the trial balance are transferred to the appropriate financial statement; for example, the cash account, which is an asset account, is shown in the debit column of the balance sheet. (See Books IV and V for more about creating financial statements.)

Account	Trial Balance		Balance Sheet		Income Statement	
	Debit	Credit	Debit	Credit	Debit	Credit
Cash	2,500.00		2,500.00			
Petty Cash	500.00		500.00			
Accounts Receivable	1,000.00		1,000.00			
Inventory	1,200.00		1,200.00			
Equipment	5,050.00		5,050.00			
Vehicle	25,000.00		25,000.00			
Furniture	5,600.00		5,600.00			
Accounts Payable		2,200.00		2,200.00		
Loans Payable		29,150.00		29,150.00		
Capital		5,000.00		5,000.00		
Sales		20,000.00				20,000.00
Sales Discounts	1,000.00				1,000.00	
Purchases	8,000.00				8,000.00	
Purchase Discounts		1,500.00				1,500.00
Credit Card Fees	125.00				125.00	
Advertising	1,500.00				1,500.00	
Bank Service Charges	120.00				120.00	
Insurance Expenses	100.00				100.00	
Interest Expenses	125.00				125.00	
Legal and Accounting Expenses	300.00				300.00	
Office Expenses	250.00				250.00	
Payroll Taxes Expenses	350.00				350.00	
Postage Expenses	75.00				75.00	
Rent Expenses	800.00				800.00	
Salaries & Wages Expenses	3,500.00				3,500.00	
Supplies	300.00				300.00	
Telephone Expenses	200.00				200.00	
Utilities Expenses	255.00				255.00	
Net Income				4,500.00	4,500.00	
Totals	57,850.00	57,850.00	40,850.00	40,850.00	21,500.00	21,500.00

Figure 5-4: This sample worksheet shows the first step in developing a company's financial statements.

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After you transfer all the accounts to their appropriate balance sheet or income statement columns, you total the worksheet columns. Don't panic when you see that the totals at the bottom of your columns aren't equal, because the net income hasn't been calculated yet. However, the difference between the debits and credits in both the balance sheet and the income statement totals should be the same. That amount should represent the net income that will appear on the income statement. (See Book IV, Chapter 2 for more about the income statement.)

In Figure 5-4, the \$4,500 difference for the balance sheet is shown as a credit, representing an increase in retained earnings. The retained earnings account reflects the profits that have been reinvested into the company's assets in order to grow the company. You can find more about retained earnings in Book IV, Chapter 5.

In some companies, earnings are taken out in the form of dividends paid to stockholders. *Dividends* are a portion of the earnings divided among stockholders. The board of directors of the corporation establishes that a certain amount per share be paid to stockholders. A company must have earnings (either from the current year or in retained earnings) to pay a dividend. If a company has no earnings at all — either in the current year or accumulated in retained earnings from past years — payments to shareholders are considered to be return of capital.

Many other small companies that haven't incorporated pay earnings to their owners by using a *drawing account*, which tracks any cash taken out by the owners. Each owner should have his or her own drawing account so that you have a history of how much each owner withdraws from the company's resources.

Replacing Worksheets with Computerized Reports

If you use a computerized accounting system, you don't have to create a worksheet. Instead, the system gives you the option of generating many different types of reports to help you develop your income statement and balance sheet.

One of the advantages of your computerized system's reports is that you can easily look at your numbers in many different ways. To get the report you want, all you do is click on the report title.

A typical computerized accounting system can generate a number of different reports within the following categories:

✓ **Profit and loss (income statement):** Some key reports in this section include

- A standard report that shows how much the company made or lost during a specific period of time
- A detail report that includes all the year-to-date transactions
- A report that compares year-to-date figures with the previous year (provided you kept the accounts by using the computerized system in the previous year)

- ✓ **Income and expenses:** Some key reports in this section include
 - Income by customer (both a summary and a detailed report)
 - Expenses by vendor (both a summary and a detailed report)
- ✓ **Balance sheet and net worth:** Some key reports in this section include
 - A standard balance sheet showing a summary of assets, liabilities, and equity
 - A detail report of assets, liabilities, and equity
 - A report that compares the assets, liabilities, and equity levels with those of the previous year
- ✓ **Cash flow:** Some key reports in this section include
 - A statement of cash flows for the year
 - A forecast of cash flows during the next few weeks or months based on money due in accounts receivable and money to be paid out in accounts payable

Computerized accounting systems provide you with the tools to manipulate your company's numbers in whatever way you find useful for analyzing your company's results. And if a report isn't quite right for your needs, you can customize it. For example, if you want to see the profit and loss results for a particular week during an accounting period, you can set the dates for only that week and generate the report. You can also produce a report looking at data for just one day, one month, one quarter, or any combination of dates.

Most computerized accounting systems, including QuickBooks, enable you to custom design reports that meet your company's unique financial information needs. Many companies customize reports to collect information by department or division. You're limited only by your imagination!



As you work with your computerized system, you'll be asked for information not easily found by using standardized reports. The first few times you pull that information together, you may need to do so manually. But as you get used to your computerized accounting system and its report functions, you'll be able to design customized reports that compile and present information in just the way you need it.

Chapter 6

Adjusting the Books

In This Chapter

- ▶ Going over types of accounting adjustments
 - ▶ Making adjustments for noncash transactions
 - ▶ Taking your adjustments for a trial (balance) run
-

During an accounting period, your bookkeeping duties focus on your business's day-to-day transactions. When the time comes to report transactions in financial statements, you must make some adjustments to your books. Your financial reports are supposed to report your company's financial condition, so your books must reflect any significant change in the value of your assets, even if that change doesn't involve the exchange of cash. Those changes are *adjustments*.

If you use cash-basis accounting, many adjustments aren't necessary because you record transactions only when cash changes hands. (See Book I, Chapter 4 to find out more about the two accounting methods: accrual and cash-basis.)

This chapter reviews the types of adjustments you need to make to the books before preparing financial statements. Adjustments include calculating asset depreciation, dividing prepaid expenses, updating inventory numbers, dealing with bad debt, and recognizing salaries and wages not yet paid.

Adjusting All the Right Areas

Even after testing your books by using the trial balance process explained in Chapter 5, you still need to make some adjustments before you're able to prepare accurate financial reports.

Adjusting entries can be grouped into four categories:

- ✔ **Converting assets into expenses:** This book defines *assets* as resources you use to make money in your business. As you use assets, those dollars become expenses. Assume that your company owns a truck. When you recognize depreciation on your truck, you make an adjusting entry to reduce the asset's value and post-depreciation expense.
- ✔ **Converting liabilities into revenue:** *Unearned revenue* is defined as payments you receive from customers before you provide a product or service. Unearned revenue is a liability account. If you don't deliver the product or service, you have to return the payment. When you pay for a one-year magazine subscription in advance, your payment represents unearned revenue to the magazine publisher. As the publisher delivers magazines to you, it moves some of your payment into earned revenue. That journal entry is an adjustment.
- ✔ **Accruing unpaid expenses:** When you owe money for an expense at the end of an accounting period, you make an adjustment to *accrue* the expense. Suppose you owe payroll to your staff for the last week of December. Your next payroll pay date is January 5. On December 31, you debit payroll expense and credit accrued payroll liability for December payroll.
- ✔ **Accruing uncollected revenue:** If you've earned revenue, but haven't yet received the payment in cash, you make an adjustment to accrue revenue. If you've earned interest on your bank balance, but haven't yet received interest from the bank, you make an adjustment. You debit (increase) accounts receivable and credit interest income (revenue) for the interest earned.



An adjusting entry always uses a balance sheet account and an income statement account. Keep that in mind when posting adjusting entries.

Here are three other specific adjustments you may make to your books:

- ✔ **Prepaid expenses:** Prepaid expenses are expenses incurred for benefits to be received in the future. This adjustment matches expenses incurred with the benefits received for a period of time. For example, if you pay an annual insurance premium with a single payment, you should move 1/12th of that payment to insurance expense each month of the year.
- ✔ **Bad debts:** Bad debt expense is posted to acknowledge that some customers will never pay. Accountants refer to the process as *writing off* a receivable account. You debit bad debt expense and credit (reduce) accounts receivable.
- ✔ **Supplies:** Many companies perform a count of the supplies they have on hand at the end of the month. They use that count to calculate the dollar amount of supplies used during the month. The adjustment is to debit supply expense and credit an asset account — supplies.

Depreciating assets

The largest noncash expense for many businesses is *depreciation*. Depreciation is an accounting chore that's important for every business because it reflects the use and decline in value of assets. (For more on depreciation and why you do it, check out Chapter 1.)

The time to adjust the books for depreciation is when you close the books for an accounting period. Some businesses record depreciation expenses every month to more accurately match monthly expenses with monthly revenues, but many business owners make depreciation adjustments only once a year, when they prepare their annual financial statements.



Depreciation doesn't involve the use of cash. By accumulating depreciation expenses on an asset, you're reducing the value of the asset as shown on the balance sheet (see Book IV, Chapter 4 for the lowdown on balance sheets).

Readers of your financial statements can get a good idea of the usefulness of your assets by reviewing your accumulated depreciation. If a financial statement shows that assets are close to being fully depreciated, readers know that you'll probably need to spend significant funds on replacing or repairing those assets sometime soon. As readers evaluate the financial health of the company, they take that future obligation into consideration before making a decision to loan money to the company or possibly invest in it.

Usually, you calculate depreciation for accounting purposes by using the *straight-line depreciation method*. This method is used to calculate an amount to be depreciated that will be equal each year based on the anticipated useful life of the asset.

For example, suppose your company purchases a car that costs \$25,000. You anticipate that car will have a useful lifespan of five years and will be worth \$5,000 after five years. Using the straight-line depreciation method, you first subtract \$5,000 from the total car cost of \$25,000 to find the value of the car during its five-year useful lifespan (\$20,000). \$20,000 represents the *depreciable base*. Next, you divide \$20,000 by 5 to find your depreciation expense for the car (\$4,000 per year). When adjusting the assets at the end of each year in the car's five-year lifespan, your entry to the books should look like this:

	<i>Debit</i>	<i>Credit</i>
Depreciation expense	\$4,000	
Accumulated depreciation: Vehicles		\$4,000
<i>To record depreciation for vehicles.</i>		

This entry increases depreciation expense, which appears on the income statement (see Book IV, Chapter 2). The entry also increases accumulated depreciation, which is the use of the asset and appears on the balance sheet directly below the vehicles asset line. The vehicle asset line always shows the value of the asset at the time of purchase (cost). So, the fixed asset section of your balance sheet after one year of vehicle depreciation would be:

Vehicle	\$25,000 (Cost)
Accumulated depreciation: Vehicles	(\$5,000)

You see several times in this book that you debit asset accounts to increase them. Accumulated depreciation is an exception to that rule — this account is a *contra-asset account* (an account with a normal balance that is the opposite of other accounts in the same category, as explained in Book IV, Chapter 3). In the previous journal entry, accumulated depreciation is credited for an increase in depreciation expense. Using a credit for accumulated depreciation allows you to present a reduction in the asset you're depreciating. So, the \$25,000 vehicle has \$5,000 in depreciation expense. Each asset in your fixed asset listing has its own accumulated depreciation account.



You can speed up depreciation if you believe that the asset will be used more heavily in the early years of ownership. Book III, Chapter 1 discusses alternative depreciation methods in greater detail.

If you use a computerized accounting system as opposed to keeping your books manually, you may not need to make this adjustment at the end of an accounting period. If your system is set up with an asset management feature, depreciation is automatically calculated, and you don't have to do it. Check with the person who set up the asset management feature before calculating and recording depreciation expenses.

Allocating prepaid expenses

Most businesses have to pay certain expenses at the beginning of the year even though they'll benefit from that expense throughout the year. Insurance is a prime example of this type of expense. Most insurance companies require you to pay the premium annually at the start of the year even though the value of that insurance protects the company throughout the year.

For example, suppose your company's annual car insurance premium is \$1,200. You pay that premium in January in order to maintain insurance coverage throughout the year. For accounting purposes, you need to match the benefit you receive (insurance coverage) with the expense of that benefit (paying insurance premiums).

As a first step, you record the cost as an asset called *prepaid expenses*, and then you adjust the value of that asset to reflect that it's being used up. Prepaid expenses are assets, because they represent costs that are already paid for. In other words, you don't have to pay the cost later — and that's an asset to you. Your \$1,200 annual insurance premium is actually valuable to the company for 12 months, so you calculate the actual expense for insurance by dividing \$1,200 by 12, resulting in a monthly expense of \$100. At the end of each month, you record the use of that asset by preparing an adjusting entry that looks like this:

	<i>Debit</i>	<i>Credit</i>
Insurance expenses	\$100	
Prepaid expenses		\$100

To record insurance expenses for one month.

This entry increases insurance expenses on the income statement and decreases the asset prepaid expenses on the balance sheet. No cash changes hands in this entry because cash was reduced when the insurance bill was paid, and the asset account prepaid expenses was increased in value at the time the cash was paid.

Counting inventory

Inventory is a balance sheet asset that needs to be adjusted at the end of an accounting period. During the accounting period, your company has several issues related to inventory:

- ✔ **Beginning inventory:** When you open your doors at the beginning of a period (month, year), you have a certain amount of inventory on hand, or *beginning inventory*.
- ✔ **Purchases:** During the month, you make purchases. You debit inventory and credit cash or accounts payable.
- ✔ **Sales:** When you sell inventory, you debit cash or accounts receivable and credit sales for the sale price. You also debit cost of sales (an expense account) and credit inventory for the cost of inventory. The difference between sales and cost of sales is your profit.

At the end of the accounting period, you adjust the inventory value to reflect your ending inventory balance. Here's the formula to calculate ending inventory:

$$\text{Beginning inventory} + \text{Purchases} - \text{Sales} = \text{Ending inventory}$$

The steps for making proper adjustments to inventory in your books are as follows:

1. Perform a physical count of ending inventory.

In addition to calculating ending inventory by using the previous formula, you should consider performing a physical count of inventory to be sure that what's on the shelves matches what's in the books. Try to perform the physical count as close as possible to the last day of the accounting period, so the physical inventory on hand will be close to your accounting record balance for the last day of the period.

2. Consider the value of your ending inventory.

The value of ending inventory varies depending on the method your company chooses to use for valuing inventory. For more about inventory value and how to calculate the value of ending inventory, see Book II, Chapter 2. As mentioned in that chapter, you should apply the same valuation method for your inventory each year. If you choose to change the method, you need a justification.

3. Adjust the ending inventory balance.

When you physically count the units of inventory and compute each unit's value, you add up the total. The total ending inventory value in the physical count may differ from that value in your accounting records. If the two values differ, you need to investigate. Either the accounting records are wrong, or your count had an error. You may need to adjust your inventory records, depending on the results of the count. That's another adjustment at the end of the period.



If you track inventory by using your computerized accounting system, the system makes adjustments to inventory as you record sales and make purchases. At the end of the accounting period, the value of your company's ending inventory should be adjusted in the books already.

Allowing for bad debts

No company likes to accept the fact that it will never see the money owed by some of its customers. Unfortunately, that's what happens to most companies that sell items on store credit. When your company determines

that a customer who has bought products on store credit will never pay for them, you record the value of that purchase as a *bad debt*. (For an explanation of store credit, check out Book II, Chapter 3.) To find out more about accounting for bad debt, continue reading the sections that follow.

Using an aging report

At the end of an accounting period, you should list all outstanding customer accounts in an *aging report* (see Book II, Chapter 3). This report shows which customers owe you money, how much they owe, and for how long they've owed you. After a certain amount of time, you have to admit that some customers simply aren't going to pay. Each company sets its own determination of how long it waits before tagging an account as a bad debt. For example, your company may decide that when a customer is six months late with a payment, you're unlikely to ever see the money.

After you determine that an account is a bad debt, you should no longer include its value as part of your assets in accounts receivable. Including its value doesn't paint a realistic picture of your situation for the people reading your financial reports. Because the bad debt is no longer an asset, you reduce the value of your accounts receivable to reflect the loss of that asset.

Selecting a bad debt method

You can record bad debts (write them off) in a couple of ways:

- ✓ **By customer:** Some companies identify the specific customers whose accounts are bad debts and calculate the bad debt expense each accounting period based on specific customer accounts.
- ✓ **By percentage:** Other companies look at their bad-debts histories and develop percentages that reflect those experiences. Instead of taking the time to identify each specific account that qualifies as a bad debt, these companies record bad debt expenses as a percentage of their accounts receivable.

However you decide to record bad debts, you need to prepare an adjusting entry at the end of each accounting period to record bad debt expenses. Here's an adjusting entry to record bad debt expenses of \$1,000:

	<i>Debit</i>	<i>Credit</i>
Bad debt expense	\$1,000	
Accounts receivable		\$1,000

To write off uncollectible customer accounts.



You can't have bad debt expenses if you don't sell to your customers on store credit. You need to deal with bad debt only if you offer your customers the convenience of buying your products on store credit.

If you use a computerized accounting system, check the system's instructions for how to write off bad debt. The following steps walk you through the process of writing off a bad debt and present an example to put all the concepts in context:

- 1. Initial accounting entries for a sale.** Suppose you sell \$1,000 in goods to Acme Painting Company. You debit accounts receivable and credit sales for \$1,000. Assume your inventory cost was \$870. You make a second entry to debit cost of sales and credit (reduce) inventory for \$870. Your profit is sales less cost of sales, or $(\$1,000 - \$870 = \$130)$.
- 2. Review your aging reports.** You review an aging report for accounts receivable each month. As time goes on, you notice that the \$1,000 Acme Painting receivable becomes older.
- 3. Attempt collection of the debt.** Every company should have a process for following up on past due amounts. In your case, you send Acme letters requesting collection and make phone calls.
- 4. Determine whether the amount is collectable.** Acme Painting goes out of business. Because the company has insufficient assets to pay its bills, you determine that the \$1,000 receivable isn't collectible.
- 5. Post the bad debt expense entry.** Knowing the specific debt isn't collectible; you debit bad debt expense and credit accounts receivable for the \$1,000 Acme owed.

Consider the impact on your business. The bad debt means that you'll collect \$1,000 less than you planned. If bad debt amounts are large, they can impact your cash flow planning. Check out Book IV, Chapter 3 for details on planning your cash flow.

Growing your sales and dealing with the issue of bad debt

Every company wants to grow, which means increasing sales. Selling more usually means selling to new customers. By definition, a new customer has no payment history, so do your homework. Many companies purchase data that documents the creditworthiness of various businesses. The data is similar to what you'd find in a personal credit report. Set financial guidelines for new clients. In addition to checking credit reports, insist that new customers pay on time. Until that client builds a track record of timely payments, you can't take the risk of the client paying late or not at all. If a new customer doesn't pay or pays late, consider whether continuing to do business with that customer is a good idea.

Suppose your company generates \$1,000,000 in sales and has bad debts totaling 2 percent of sales (\$20,000). Next year, you're able to grow sales by \$200,000, with bad debt on your new sales of \$10,000. A \$10,000 bad debt level is 5 percent of your new sales ($\$10,000 \div \$200,000$). Your bad debt as a percentage of sales for the entire \$1,200,000 is \$30,000, or 2.5 percent. You sold more, but your bad debt expense (both in total dollars and as a percentage of sales) increased.

Increasing sales is good, but if your collections on the new total sales amount decline, you have a problem. A larger bad debt expense can result in lower profit. In the previous example, bad debt expense increased from 2 to 2.5 percent of sales. Profit declined by 0.5 percent for every dollar in sales revenue.

Recognizing unpaid salaries and wages

Not all pay periods fall at the end of a month. If you pay your employees every two weeks, you may end up closing the books in the middle of a pay period. For example, assume employees aren't paid for the last week of March until the end of the first week of April. Your fiscal period ends on March 31, which isn't a payroll pay date.

In this case, you need to make an adjusting entry to record the payroll expense incurred but not yet paid, also called *accrued payroll*. You estimate the amount of the adjustment based on what you pay every two weeks. Here's how you can accrue for payroll:

- 1. Calculate your daily payroll expense.** Take your total payroll for the period (both before and after the end of the period) and divide that amount by the number of days in the pay period. Typically a pay period is two weeks. Assume your two-week payroll is \$2,800. Your daily payroll accrual is ($\$2,800 \div 14 \text{ days} = \200 per day).
- 2. Compute payroll accrual.** Compute the number of days to be accrued. In this case, assume you need to accrue 7 days — the last week of March. Your payroll accrual is ($7 \text{ days} \times \$200 \text{ per day} = \$1,400$).
- 3. Post your accrual entry.** Here's the entry you post on March 31 to accrue unpaid March payroll:

	<i>Debit</i>	<i>Credit</i>
Payroll expenses	\$1,400	
Accrued payroll expenses		\$1,400
<i>To record payroll expenses for the last week of March.</i>		

After the cash is actually paid out, you reverse the accrual entry. You debit to reduce the liability account (accrued payroll expenses) and credit cash account, to account for the payment. Doing these extra entries may seem like a lot of extra work, but if you didn't match the payroll expenses for March with the revenues for March, your income statements wouldn't reflect the actual state of your affairs. Without the payroll accrual, your March payroll would be understated.

Testing an Adjusted Trial Balance

In Chapter 5, you find out why and how you run a trial balance on the accounts in your general ledger. Adjustments to your books call for another trial balance, the *adjusted trial balance*, to ensure that your adjustments are correct and ready to be posted to the general ledger. You track all the adjusting entries on a worksheet similar to the one shown in Chapter 5. You need to use this worksheet only if you're doing your books manually. It's not necessary if you're using a computerized accounting system.

The key difference in the worksheet for the adjusted trial balance is that additional columns must be added to the worksheet. Columns include

- ✓ **Column 1:** Account titles.
- ✓ **Columns 2 and 3:** Unadjusted trial balance — the trial balance before the adjustments are made — with Column 2 for debits and Column 3 for credits.
- ✓ **Columns 4 and 5:** Adjustments. All adjustments to the trial balance are listed in Column 4 for debits and Column 5 for credits.
- ✓ **Columns 6 and 7:** Adjusted trial balance. A new trial balance is calculated that includes all the adjustments. Be sure that the credits equal the debits when you total that new trial balance. If they don't, find any errors before posting entries to the balance sheet and income statement columns.
- ✓ **Other columns:** Use data from the adjusted trial balance columns and create columns for a balance sheet and an income statement.

When you're confident that all the accounts are in balance, post your adjustments to the general ledger so that all the balances in the general ledger include the adjusting entries. With the adjustments, the general ledger can be used to generate financial statements. After you finalize your general ledger for the year, you may want to make changes to your chart of accounts, which lists all the accounts in your accounting system. You may add or subtract accounts, depending on the activity in your business.