Ch.10 Financial Statements and Closing Entries for a Merchandising Business

- Prepare financial statements for a merchandising business
- Journalize adjusting and closing entries for a merchandising business
- Prepare a post-closing trial balance
- Make reversing entries for accrued (unpaid) salaries

Financial Statement Preparation

- The financial activities of a business are recorded in journals and posted to ledgers throughout the accounting period.
- At the end of the period, a work sheet is prepared to organize and summarize data.
- The completed work sheet is then used to prepare financial statements.
- Financial statements provide managers and owners with the primary information they need in order to make sound decisions about the future of a business.

Sections of the Classified Income statement

- Revenue
- Cost of Goods Sold
- Operating Expenses
- Income from Operations
- Other Income and Expenses

	Net Sales for the Period
−	**Cost of Goods Sold**
=	Gross Profit
−	Operating Expenses
=	Income from Operations
+	Other Income
−	Other Expenses
=	Net Income

Terms on a Classified Income Statement

- Gross Profit — the profit before subtracting the expenses of doing business
  - Calculated by subtracting cost of goods sold from net sales
  - Also referred to as gross margin
- Cost of Goods Sold — the cost of merchandise sold to customers during the accounting period
- Net Sales — the amount obtained by subtracting the amount of sales returns and allowances and the amount of sales discounts from the amount of sales

The Revenue Section

Provides a figure for net sales, which is the balance of the Sales account, less the balances of the Contra Sales accounts (Sales Returns and Allowances and Sales Discounts).

Contra Revenue Accounts

Total Sales

Lakeside Electronics
Income Statement (Partial)
For Year Ended December 31, 20X1

Revenue from sales:			
Sales		$304,600.00	
Less: Sales returns and allowances	$5,230.00		
Sales discounts	3,461.00	8,691.00	
Net sales			$295,909.00

The Cost of Goods Sold Section

The cost of merchandise sold to customers during a period is subtracted from the net sales figure for the same period to get the amount of *gross profit* .

Lakeside Electronics
Income Statement (Partial)
For Year Ended December 31, 20X1

Net sales				$295,909.00
Cost of goods sold:				
Merchandise inventory, January 1			$ 66,000.00	
Purchases		$144,918.00		
Less: Purchases ret. and allow.	$6,692.00			
Purchases discounts	2,910.00	9,602.00		
		$135,316.00		
Add: Freight in		1,160.00		
Net purchases			136,476.00	
Goods available for sale			$202,476.00	
Less: Merch. inv., December 31			72,400.00	
Cost of goods sold				130,076.00
Gross profit				$165,833.00

Contra purchase accounts

Operating Expenses

- The regular expenses of operating the business
- Most companies divide into selling expenses and general expenses
    - Selling Expenses — all expenses directly related to the sale of merchandise
        - ✓ Sales Salaries Expense
        - ✓ Advertising Expense
        - ✓ Store Supplies Expense
        - ✓ Depreciation Expense - Store Equipment
        - ✓ Miscellaneous Selling Expense

Operating Expenses

- General Expenses — expenses related to the business's office, the overall administration of the business's office, or any other operating expenses that cannot be tied directly to sales activity
  - ✓ Office Salaries Expense
  - ✓ Rent Expense
  - ✓ Depreciation Expense - Office Equipment
  - ✓ Utilities Expense
  - ✓ Miscellaneous General Expense

Operating Expenses

Lakeside Electronics
Income Statement (Partial)
For Year Ended December 31, 20X1

Gross profit			$165 8 3 3 00
Operating expenses:			
Selling expenses:			
Sales salaries expense	$69 1 0 0 00		
Advertising expense	5 8 4 0 00		
Store supplies expense	1 5 1 5 00		
Depr. exp.—store equipment	9 0 0 00		
Miscellaneous selling expense	2 1 0 0 00		
Total selling expenses		$79 4 5 5 00	

Operating Expenses

Lakeside Electronics
Income Statement (Partial)
For Year Ended December 31, 20X1

General expenses:			
Rent expense	$ 5,700.00		
Office salaries expense	31,153.00		
Insurance expense	90.00		
Depr. exp.—office equipment	820.00		
Depr. exp.—delivery equipment	9,200.00		
Utilities expense	6,240.00		
Office supplies expense	417.00		
Miscellaneous general expense	900.00		
Total general expenses		54,520.00	
Total operating expenses			133,975.00

Income from Operations

- Equals gross profit minus total operating expenses
- A measure of a firm's ongoing operations

Lakeside Electronics Income Statement (Partial) For Year Ended December 31, 20X1	
Gross profit	$165,833.00
Total operating expenses	133,975.00
Income from operations	$ 31,858.00

Had operating expenses exceeded gross profit, there would have been a loss from operations.

Other Income and Expenses

- Other Income
  - Revenue earned not directly associated with the normal operation of the business
  - Such as income from vending machine sales or interest earned
- Other Expenses
  - Expenses not directly associated with the normal operation of the business
  - Such as interest expense

Other Income and Expenses

Lakeside Electronics
Income Statement (Partial)
For Year Ended December 31, 20X1

Income from operations	$31 8 5 8 00
Other expenses:	
Interest expense	1 3 0 00
Net income	$31 7 2 8 00

Completed Income Statement

Calculation of net sales

Calculation of gross profit

Lakeside Electronics
Income Statement
For Year Ended December 31, 20X1

Revenue from sales:				
Sales			$304,600.00	
Less: Sales returns and allowances		$ 5,230.00		
Sales discounts		3,461.00	8,691.00	
Net sales				$295,909.00
Cost of goods sold:				
Merchandise inventory, January 1			$ 66,000.00	
Purchases		$144,918.00		
Less: Purchases ret. and allow.	$6,692.00			
Purchases discounts	2,910.00	9,602.00		
		$135,316.00		
Add: Freight in		1,160.00		
Net purchases			136,476.00	
Goods available for sale			$202,476.00	
Less: Merch. inv., December 31			72,400.00	
Cost of goods sold				130,076.00
Gross profit				$165,833.00

Completed Income Statement

Calculation of income from operations

Calculation of net income

Lakeside Electronics Income Statement For Year Ended December 31, 20X1			
Operating expenses:			
Selling expenses:			
Sales salaries expense	$69,100.00		
Advertising expense	5,840.00		
Store supplies expense	1,515.00		
Depr. exp.—store equipment	900.00		
Miscellaneous selling expense	2,100.00		
Total selling expenses		$79,455.00	
General expenses:			
Rent expense	$5,700.00		
Office salaries expense	31,153.00		
Insurance expense	90.00		
Depr. expense—office equip.	820.00		
Depr. expense—delivery equip.	9,200.00		
Utilities expense	6,240.00		
Office supplies expense	417.00		
Miscellaneous general expense	900.00		
Total general expenses		$54,520.00	
Total operating expenses			133,975.00
Income from operations			$31,858.00
Other expenses:			
Interest expense			130.00
Net income			$31,728.00

Statement of Owner's Equity

The link between the income statement and the balance sheet

- The net income (or net loss) figure from the income statement is entered on the statement of owner's equity as a necessary part of updating the owner's capital.
- This updated capital is then entered on the balance sheet.

Statement of Owner's Equity

Lakeside Electronics Statement of Owner's Equity For Year Ended December 31, 20X1			
John Graham, capital, January 1			$75 5 8 1 00
Net income for period		$31 7 2 8 00	
Less: Withdrawals		18 0 0 0 00	
Increase in capital			13 7 2 8 00
John Graham, capital, December 31			$89 3 0 9 00

From income statement

Classified Balance Sheet

- The principal objective of the balance sheet is to present the reader with as much information as possible about the financial condition of a business at a particular point in time.
- A classified balance sheet groups items into classifications in the asset, liability, and owner's equity section of the balance sheet.

Assets

- Current Assets — cash and other assets that through normal operations are expected, to be
  - Sold
  - Converted to cash
  - Used up
  - Expired
  - Used within one year of the balance sheet date

- Plant Assets
  - Assets that are expected to be used in the business for more than one year
  - Acquired for use in the operation of a business
  - Not intended for resale to customers
  - Tangible
  - Examples: land, buildings, machinery and equipment, furniture, and automobiles

Liabilities

- Current Liabilities
  - Short - term liabilities, due for payment within one year
  - Examples: accounts payable, salaries payable, current portion of notes payable
- Long-Term Liabilities
  - Debt that will not come due for payment within one year
  - Examples: long-term notes payable, mortgages payable
- The balance sheet requires an up-to-date amount for the owner's capital.
- This amount will be supplied by the statement of owner's equity.

Classified Balance Sheet

Lakeside Electronics Balance Sheet December 31, 20X1			
Assets			
Current assets:			
Cash		$ 6,200.00	
Accounts receivable		9,689.00	
Merchandise inventory		72,400.00	
Store supplies		500.00	
Office supplies		250.00	
Prepaid insurance		630.00	
Total current assets			$ 89,669.00
Plant assets:			
Store equipment	$11,385.00		
Less: Accumulated depreciation	5,400.00	$ 5,985.00	
Office equipment	$10,200.00		
Less: Accumulated depreciation	7,920.00	2,280.00	
Delivery equipment	$56,000.00		
Less: Accumulated depreciation	23,000.00	33,000.00	
Total plant assets			41,265.00
Total assets			$130,934.00

The balance sheet is dated as of the last day of the fiscal period.

book value

Classified Balance Sheet

Lakeside Electronics Balance Sheet December 31, 20X1			
Liabilities			
Current liabilities:			
Accounts payable	$14 0 2 5 00		
Salaries payable	1 6 0 0 00		
Total current liabilities		$15 6 2 5 00	
Long-term liabilities:			
Notes payable		26 0 0 0 00	
Total liabilities			$ 41 6 2 5 00
Owner's Equity			
John Graham, capital			89 3 0 9 00
Total liabilities and owner's equity			$130 9 3 4 00

Working Capital

- Computed as current assets minus current liabilities
- Represents the funds available to replace inventory and to acquire credit

Current Ratio

- Computed as current assets divided by current liabilities
- Gives an indication of the ability of a business to pay its current liabilities

Journalizing Adjusting Entries

- The work sheet is useful for recording adjustments
- However, the worksheet is not a journal, and no posting is ever made from the work sheet to the ledger
- To get the adjusting entries into the ledger, formal journal entries must be made
- Adjusting entries are dated as of the last day of the accounting period

Objectives of the Closing Process

- To reduce the balances of the temporary accounts to zero and thus make the accounts ready for entries in the next accounting period
- To update the balance of the owner's capital account

Steps in the Closing Process

- ✓ Step 1 Close the Sales account and other income statement accounts with credit balances to the Income Summary account.
- ✓ Step 2 Close each expense account and other income statement accounts with debit balances to the Income Summary account.
- ✓ Step 3 Close the Income Summary account to the owner's capital account.
- ✓ Step 4 Close the balance of the owner's drawing account to the owner's capital account.

The Post-Closing Trial Balance

- Prepared after the adjusting and closing entries have been posted
- The purpose — to prove that the ledger is still in balance
- The only accounts appearing on the post-closing trial balance are the permanent accounts because the temporary accounts have been closed.
  - Permanent accounts: assets, liabilities, and owner's equity
  - Temporary accounts: revenue, expenses, and drawing

Reversing Entries

- Avoids allocating amounts between two accounting periods in the entry to record payment of an accrued expense
- Optional, but used extensively in practice
- Eliminates the balance of the liability account and sets up a credit balance in the expense account
- Intended to simplify the bookkeeping for transactions that involve accrued expenses
- Always made as of the first day of the next accounting period — never on the last day of the period

Interim Statements

- Financial statements prepared during the fiscal year for periods of less than 12 months, such as monthly, quarterly, and semiannually
- To prepare, the accountant assembles adjustment data for the interim period
- The adjustments are entered on a work sheet, and the interim statements are prepared from the completed work sheet
- The adjusting and closing entries are not journalized; thus they are not entered in the ledger
- Those entries are recorded only at the end of the fiscal year