

Daubert, Madeline J. (1995).
Money Talk: Accounting Fundamentals for Special Librarians.
Special Library Association. (pp.12-31)

Chapter III

The Language of Accounting

In order to communicate effectively with other financial managers, it will help if you understand the language of accounting. This chapter and those that follow will introduce and explain many of the fundamental concepts of accounting.

Entity Concept

For accounting purposes, every organization is a separate economic unit; this is known as the *entity concept* of accounting. For example, your organization's funds must be kept separate from its owners' funds, from your personal funds, and from the funds of any of its investors or creditors. For accounting purposes, it is important for a separate entity to be recognized. Although most accounting rules are established for business purposes, an economic entity does not necessarily have to be a business; it may be a club, a family, or an individual. Whether your organization is a corporation, a partnership, or a sole proprietorship, it is important to keep the money of the company separate from that of its owners.

Money Measurement

Another basic accounting concept is *money measurement*; all changes in the financial position of an entity are measured in terms of money. While you may often measure the success of your information center in terms of materials circulated or questions answered, only measures in terms of money are relevant in accounting. For accounting purposes, the value of your library's holdings would not be measured in terms of numbers of books or quantities of software, but in dollars. To communicate effectively with financial managers, you must often find ways to value your services in terms of dollars. For example, online research services provided by a librarian probably cost far less than if a highly-paid attorney (unfamiliar with the system) used those same services.

Any economic event changing the financial condition of an entity is called a *transaction*, and is recorded in terms of money. The receipt of a donation or a payment for service; the purchase of a book or computer; the payment of salaries or insurance premiums for employees; the loss of materials due to theft or the discard of materials due to obsolescence are all examples of transactions that would be recorded and would affect the financial position of an organization.

How is financial information recorded? First, financial information is sorted and stored in *accounts*, so all transactions affecting a specific account are stored together. Just as similar materials in a library are classified together, similar accounts in an accounting system are grouped together. The arrangement of accounts in an organization is called a *chart of accounts*. Although some small organizations may still use verbal descriptions for each account, most organizations assign numeric codes. The concept of the chart of accounts is very similar to the concept of classification systems used in libraries, and you can probably find many similarities between your organization's chart of accounts and the Dewey Decimal System or the Library of Congress classification system.

The basic types of accounts include assets, liabilities, equity, revenue, and expense. *Assets* are resources owned by the organization; assets may be monetary or nonmonetary. Monetary assets consist of cash and claims on cash, such as receivables (money owed to the organization). In accounting, "cash" is referred to as money that is readily available, and in actuality usually refers to a check or money in the bank—not dollar bills! Noncash items such as land, buildings, books, furniture and equipment are nonmonetary assets.

Current assets are expected to be used within one year; examples would be cash to pay for salaries or supplies in the near future, or investments intended to be converted to cash to pay for expenses during the next year. *Long-term assets* are expected to last longer than one year; examples are land, buildings, books

may be worth far less. This can be a major problem, particularly if the actual value of the assets is not sufficient to pay off the organization's liabilities.

Liabilities are the obligations of the organization, and may include amounts due to vendors, income received but not yet earned, wages due to employees, mortgages on land or buildings, or other funds borrowed from outsiders. These liabilities represent claims others may have against the assets of the organization; creditors have legal priority over owners and may force a company's assets to be sold for the payment of debts if the company has not paid its bills. For this reason it is particularly important for a company to have enough cash to pay its current liabilities. A company with a large amount of nonmonetary assets and little cash may be forced to dispose of some assets at less than their actual value in order to raise cash to pay its debts; it might also be forced to sell its product at a lower than desired cost in order to attract a larger number of buyers.

The difference between the assets and liabilities of an organization is called *equity*; this term may vary depending on the type of organization being discussed. Other terms with similar meaning are *owner's equity*, *stockholder's equity*, *fund balance* (for nonprofit organizations), and *net worth* (for individuals). Individuals or businesses who own shares of stock in a corporation own part of the equity of the corporation.

The Balance Sheet Equation

We have just seen that assets minus liabilities equals equity, or:

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

This equation may also be stated in the form:

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

This form of the equation is known as the *balance sheet equation*, since the format of an important financial statement—the balance sheet—derived from this equation.

To illustrate the balance sheet equation, let's look at the following example:

1. Assume your checking account currently has \$100 in it, and this is your sole possession; you have no debts. Shown in the balance sheet format:

$$\text{Assets} = \text{Liabilities} + \text{Equity} \quad \$100 = \$0 + \$100$$

Your assets are \$100; your equity is also \$100.

2. Now assume you receive a gift of \$40, which you deposit into your account:

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

$$\$140 = \$0 + \$140$$

With this transaction, you have increased your assets by \$40; your equity also increased by \$40.

3. You purchase a rare book for \$25 and write a check for that amount:

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

$$\$115 + \$25 = \$0 + \$140$$

(Cash + Book)

Your assets are no longer all in the form of cash, but the book is recorded as a \$25 asset, so your equity has not changed.

4. Next you buy a calculator for \$30 and charge it to your credit card:

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

$$\$115 + \$25 + \$30 = \$30 + \$140$$

(Cash + Book + Calculator)

With this transaction, you have theoretically increased your assets by \$30 by the purchase of the calculator. You can probably see that recording all assets at cost presents some problems in reflecting your true financial situation. Because you did not pay for the calculator at the time, you now have a liability of \$30.

With the preceding transactions, your assets have changed from \$140 in cash (a monetary asset) to \$140 consisting of \$85 in cash, a \$25 book (nonmonetary), and a \$30 calculator (nonmonetary). Do you think you could easily convert this back to \$140 in cash? This example should help you to understand some of the problems involved with accounting for nonmonetary assets.

In an organization, many transactions take place that affect equity. If an owner invests more money in his own company (or contributes nonmonetary assets, such as land, vehicles, buildings, etc.), both the assets and the equity of the company are increased. Large companies may sell additional shares of stock in order to raise cash; by doing this they increase their monetary assets at the same time they increase their shareholders' equity.

Changes among the different accounts occur as a result of an organization's financial activity. Most changes to equity do not occur directly, but rather occur as a result of changes in the assets or liabilities. Increases in assets earned through operations are *revenues*, while the cost of goods and services used are *expenses*. The difference between total revenues and total expenses is the net income of the business; a for profit organization is especially concerned if revenues over a period of time exceed expenses. Expenses decrease equity, whether by decreasing assets or by increasing liabilities. Let's continue with the previous example to demonstrate this, beginning where we stopped:

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \text{Equity} \\ \$85 + \$25 + \$30 &= \$0 + \$140 \\ (\text{Cash} + \text{Book} + \text{Calculator}) \end{aligned}$$

6. You take a taxi to a restaurant, and write the driver a check for \$7.

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \text{Equity} \\ \$78 + \$25 + \$30 &= \$0 + \$133 \\ (\text{Cash} + \text{Book} + \text{Calculator}) \end{aligned}$$

You have decreased your checking account by \$7; you have not increased your assets in any way and so have decreased your equity.

7. You eat dinner in a restaurant and spend \$20, charging it to your credit card:

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \text{Equity} \\ \$78 + \$25 + \$30 &= \$20 + \$113 \\ (\text{Cash} + \text{Book} + \text{Calculator}) \end{aligned}$$

You have increased your liabilities by \$20; you have not increased your assets so you have again decreased your equity. Both the taxi and the dinner are examples of expenses, since they decreased your equity.

Many of the simplest accounting systems begin by recording transactions whenever cash is paid out or received; this is known as the cash basis of accounting. However, a cash payment may not necessarily be made at the time a service or product is received. In the previous example, the restaurant meal was charged to a credit card; although the cash had not yet been paid, the expense had been incurred.

Because the cash basis of accounting does not reflect unpaid bills, it may not portray an organization's true financial situation, and is not in accordance with generally accepted accounting principles. It is a simple method, however, and may sometimes be adequate for short-term management and internal reporting.

The Matching Concept Cash and Accrual Accounting

The *matching concept* of accounting states that revenues must be matched with the time period when they were earned, and expenses must be matched with the period when they were incurred. To apply the matching concept to the cash basis of accounting, adjustments must be made for revenues earned but not received and for expenses incurred but not paid. This is called the *accrual basis* of accounting. In our discussion of the balance sheet equation, the \$20 liability for the restaurant meal was recognized as a liability (and as an expense) at the time it was charged to the credit card; this is consistent with the

restaurant meal to a credit card, we must recognize an expense and a liability when library materials are received. With the accrual basis, an adjustment is made to record the expense of these materials and also to record the liability. If your information center charges outside users for information services, money due you for services already provided would be unrecorded revenues when the cash basis of accounting is used; to make an adjustment for the accrual basis of accounting, the revenue would be recorded and so would the corresponding asset, a receivable.

It is important to note that an expense is not incurred until the merchandise is *received*; there is no liability or expense until that time. There are exceptions, such as an order for a customized product (the liability is incurred when the customization of the product begins), or in cases where the customer assumes responsibility for the product at the shipping point instead of the receiving point. You do not have a liability or an expense at the time you place the order; however, it is important to keep track of your outstanding orders so you do not order beyond your budgeted amount. Many organizations keep specific records of outstanding orders and reduce available budget funds when orders are placed; this prevents departments from accidentally ordering more than they have budgeted.

In accordance with the matching concept, the expense of using some long-term assets is spread over the period of time during which those assets are used. Furniture, for example, is used for many years, so its expense cannot be totally matched to one time period; instead, portions of the expense are charged to several years following its purchase. This process of allocating an expense over a long period of time is called *depreciation*. There are many methods of accounting for depreciation, some fairly simple and some quite complex.

In order for the matching concept to be applied, some time period must be defined. Some organizations make adjustments on a monthly basis, while others only find it necessary to make these adjustments on a quarterly or annual basis. Because the accrual basis of accounting is more accurate than the cash basis in reflecting an organization's true financial position, it is likely to be used whenever the organization is producing important financial reports.

A standard time period used in accounting is the fiscal year, which is simply a 12-month period. It may be the calendar year, or it may be some other 12-month period more closely corresponding to the business cycle of the organization. Budgets are usually prepared for one fiscal year, taxes are paid for each fiscal year, and most important accounting reports are based on a time period of one fiscal year. Usually it is desirable to end a fiscal year shortly after the most active season for a business; reporting reflects the most recent activity, and financial records may be reviewed and adjusted during the slow period.

It is important to know when your organization's fiscal year begins and ends, and to pay particular attention to when items are received during those periods. For example, if your company has a fiscal year of January 1 - December 31, books and materials received on December 31 are recorded as an expense in one fiscal year, while books and materials received the next day, on January 1, are recorded as an expense in the next fiscal year. If you have a certain amount of budgeted funds available for the current fiscal year, you need to be sure to order materials early enough to receive them in this fiscal year. This will allow them to be charged to the appropriate year and not cause you to be over-budget in the following year. Some organizations adjust for this but many do not; it is easier to plan accordingly.

Summary

Each organization must function as a separate economic unit, and all economic events, or transactions, must be measured in terms of money. Information concerning transactions is stored in accounts, classified as assets, liabilities, equity, revenues, and expenses, and arranged in a chart of accounts. Assets are resources owned by the organization, while liabilities are debts of the organization; the difference between assets and liabilities is owner's equity. The balance sheet equation, stated as $\text{Assets} = \text{Liabilities} + \text{Equity}$ provides a basis for understanding the changes taking place in accounts through financial activity.

Because the matching rule of accounting states that revenue should be recognized when earned and expenses should be recognized when incurred, adjustments are made at the end of each accounting period to convert cash basis accounting records to an accrual basis. This is particularly important at the end of each fiscal year, the end of the 12-month period when final accounting reports are prepared.

The accounting terms and concepts discussed in this chapter should help you communicate with your accounting department and other financial managers concerning activities affecting your library. Because these concepts are valid for individuals as well as all types of businesses, this knowledge should also help you understand financial information in your personal life.

Chapter IV

Using Accounting Information

Now that you have been introduced to some of the concepts of accounting, it is time to increase your understanding with some practical applications.

T Accounts-Debits and Credits

As previously stated, the basic storage unit for accounting data is the account. For purposes of analysis, an account can be seen as having three parts: (1) a title describing the account; (2) a left side, called the *debit* side; and (3) a right side, called the *credit* side. This appears as follows:

Title of Account	
Left Side (Debit)	Right Side (Credit)

Because this form resembles the letter “T,” it is called a “T account,” and is used in accounting to analyze transactions.

The use of T accounts to analyze transactions may help you understand some of the fundamentals of accounting. The basic method of accounting is the *double-entry system*, which has been in use for hundreds of years. In 1494 this system was described in a mathematics book by Fra Luca Pacioli, a Franciscan monk and friend of Leonardo da Vinci. In the double-entry system there are two entries for each transaction, one debit entry and an equal credit entry. When one account is increased with a credit, some corresponding account is increased with a debit. Because total debits and total credits are always equal, the system is always in balance. The words “debit” and “credit” are derived from the Latin words meaning “left” and “right,” not “decrease” and “increase.”

Most people are familiar with terminology used in relation to their bank checking accounts, and know when they put money in, the bank “credits the account.” When they take money out, the bank “debits the account.” Because of this, there is a natural inclination to feel that any account is increased with a credit and decreased with a debit. This is not the case. When you deposit \$50 in cash in your checking account, the bank *credits* your checking account for \$50, and at the same time *debits* the cash in the bank. Your checking account is increased with a credit, and the bank’s cash is increased with a debit. When you write a check, your checking account is decreased with a debit, and the bank’s cash is decreased with a credit.

Let’s look at some examples similar to situations you might encounter in your library, and illustrate them with T accounts and the double-entry system.

Let’s assume you receive a \$500 donation for your library, which you deposit in your library account; the \$500 donation is revenue to the library. When we increase a revenue account, we *credit* the account. According to the rules of double entry, if there is a credit to one account, we must debit another account. Since we know an increase in revenue also results in an increase in assets, we know the other side of the entry must be a debit to an asset account. In this case we are increasing the revenue account with a credit and are also increasing the asset, cash, with a debit to the account.

The following T accounts show this transaction-note that *at least two T* accounts must be involved, since there must be a debit to one account and a credit to another. The \$500 is entered on the left, or debit side, of the Library Cash account, and on the right, or credit side, of the Library Revenue account.

Library Cash	Library Revenue
\$500	\$500

Next you order several books for your library; the order arrives along with a bill for \$300. Until the bill is paid, it represents

Library Accounts Payable	Library Books Expense
\$300	\$300

A few days later you-or more likely, your accounting department-pay the bill for \$300. Since we increase cash with a debit, we decrease it with a credit; we previously increased accounts payable with a credit, so will decrease it with a debit. The following entry is made:

Library Cash	Library Accounts Payable
\$300	\$300

Combining these transactions, we have:

Library Cash	Library Revenue
\$500	\$500
\$300	

Library Accounts Payable	Library Books Expense
\$300	\$300
	\$300

It is possible to have numerous entries on both sides of the T accounts; the *account balance* is the difference between the total debits and the total credits. As you can see, you would have \$200 remaining in your Cash account, your Revenue account would have \$500, and your Books Expense account would have a balance of \$300, but your Accounts Payable balance would be \$0.

Because revenues increase assets, each revenue transaction will have a corresponding asset transaction. Note the credit to the revenue account *increases* the asset, cash, with a corresponding *debit* entry. Following the rules of double entry, that every credit transaction must have a corresponding debit transaction, we can see that if revenues are increased by credits, then assets are increased by debits.

If debits increase assets, then liabilities and equity must be increased by credits. You can also see if a credit decreases assets, then the opposite, a debit, must be used to decrease liabilities or equity. The following rules summarize this:

Assets	=	Liabilities	+	Equity
Debit for Increases		Debit Decrease		Debit Decreases
Credit for Decreases		Credit for Increase		Credit for Increases

You may have gone through your checkbook or other financial records to see exactly how much income you received from certain sources, or how much you spent on certain types of items. Businesses also keep track of their different sources of revenue and types of expense. Rather than sorting through a thick checkbook, however, these items are tracked through separate accounts. These accounts may have verbal descriptions, or they may be assigned numeric codes, which provide many advantages when computers are used. Large organizations will probably have hundreds of accounts to separate their assets, liabilities, revenues, and expenses, although there are usually only a few equity accounts.

If you work in a library that is part of a larger organization, your library probably has its own account code or codes. These codes may have several different names, such as department code, budget center, cost center, or a variety of other titles. In a very simple structure, your account might simply be called “Library,” but in a more complex system your account probably is numeric. Let’s assume your library’s account code is 36000.

Your company probably also has another set of codes for various types of revenues and expenses. These may be called detail codes, object codes, line items, expenditure codes, subcodes, or many other names. In some systems words may be used, such as Materials Expense, Travel Expense, etc., but in most systems each type of revenue and expense will be assigned a numeric code, such as 200 for Materials Expense and 300 for Travel Expense.

For the following example, the subcode used for cash is 001, and the subcode used for revenue is 050. We will use the subcode 550 for Books Expense, and the subcode 009 for Accounts Payable.

Adding the numeric account codes to our previous example would yield this result:

<p>36000-001 Library Cash</p> <hr style="width: 100%;"/> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; text-align: center; border-right: 1px solid black;">\$500</td> <td style="width: 50%;"></td> </tr> <tr> <td style="border-right: 1px solid black;"></td> <td style="text-align: center;">\$300</td> </tr> </table>	\$500			\$300	<p>3600-050 Library Revenue</p> <hr style="width: 100%;"/> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;"></td> <td style="width: 50%; text-align: center; border-left: 1px solid black;">\$500</td> </tr> </table>		\$500
\$500							
	\$300						
	\$500						
<p>36000-009 Library Accounts Payable</p> <hr style="width: 100%;"/> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; text-align: center; border-right: 1px solid black;">\$300</td> <td style="width: 50%; text-align: center;">\$300</td> </tr> </table>	\$300	\$300	<p>36000-550 Library Books Expense</p> <hr style="width: 100%;"/> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; text-align: center; border-right: 1px solid black;">\$300</td> <td style="width: 50%;"></td> </tr> </table>	\$300			
\$300	\$300						
\$300							

Using a system such as this enables an organization to track its revenues and expenses fairly easily. For example, by combining all the accounts beginning with “36000,” a summary of all the library’s assets, liabilities, revenues, and expenses could be obtained. Or, by combining all the accounts ending with “550”, a summary of all the book expenses for the entire company could be obtained. Using numeric codes such as this makes computerized sorting and reporting fairly simple.

T accounts are helpful for analyzing individual transactions and for understanding the double entry system, but they are far too cumbersome for everyday use. By now most organizations use some type of computerized accounting system, but these systems are based on the double-entry system and are simply programmed to perform many parts of the transactions you have just seen. Prior to computerization, manual bookkeeping systems were used (and are still used in some small organizations), and the same rules of accounting apply in both manual and computerized systems. To understand some of the terminology used in accounting systems, we will briefly outline how a manual accounting system works.

Ledgers and Journals

Accounting information may be entered chronologically in a *journal*, in which the following information is recorded for each transaction: the date, the names of the accounts debited and credited, the dollar amounts of each debit and credit, and an explanation of the transaction. If the accounts have numeric codes, this information will also be included.

A separate journal entry records each transaction, and the information is later transferred to the *ledger*, which is the system for filing information on all the accounts. The process of transferring information from the journal to the ledger is called *posting*; for each account, each amount in the debit column of the journal is transferred to the debit column of the ledger, and each amount in the credit column of the journal is transferred to the credit column of the ledger. All transactions affecting a particular account are eventually recorded in that account; by reviewing the ledger for a particular account, you can actually trace its entire history.

The examples shown in the previous T accounts are shown here in journal and ledger format:

JOURNAL Page 1

Date	Description	Post	Debit	Credit
01/04	Library Revenue-donation	050		500
	Cash	001	500	
01/06	Library Books Expense	550	300	
	Accounts Payable	009		300
01/08	Accounts Payable	009	300	
	Cash	001		300

These items, from Journal Page 1, are next posted to the separate accounts in the ledger. By referring to “J 1,” one can trace the transaction back to the original journal and the description entered at the time. In an actual situation, more information would probably be entered in the journal so the original transaction could be clearly identified.

LEDGER

CASH Account No. 001

Date	Item	Post Ref	Debit	Credit	Balance	
					Debit	Credit
01/04	donation	J1	500		500	
01/08	books	J1		300	200	

ACCOUNTS PAYABLE Account No. 009

Date	Item	Post Ref	Debit	Credit	Balance	
					Debit	Credit
01/06	books	J1		300		300
01/08	payment	J1	300			0

LIBRARY REVENUE Account No. 050

Date	Item	Post Ref	Debit	Credit	Balance	
					Debit	Credit
¼	donation	J1		500		500

LIBRARY BOOKS EXPENSE Account No. 550

Date	Item	Post Ref	Debit	Credit	Balance	
					Debit	Credit
01/06	books	J1	300	300	300	

To assure that the debit and credit balances in the ledger are always equal, a *trial balance* is prepared periodically. This is done by listing each ledger account with a balance, with debit balances in one column and credit balances in another. Each column is added and the totals are compared; if total debits do not equal total credits, an error has been made and must be located. Let’s look at a trial balance using the previous accounts:

TRIAL BALANCE
01/09/1999

	Debit	Credit
Cash	200	
Revenue		500
Books Expense	300	
	500	500

When errors are located, they are usually corrected by a *journal entry*. This creates a new transaction at the original source, the journal, and this entry will then be posted to the correct accounts in the ledger. Let's look at our previous example and assume we had discovered an error in accounting for the Books Expense, and it should really have been recorded as Supplies Expense. Since there has been a debit entry to Books Expense, we need to correct it with an equal credit entry; the net result will then be zero. If we credit Books Expense to make the correction, we would then debit Supplies Expense; the T accounts to analyze this would be as follows (beginning with our previous balance of \$300 in Library Books Expense):

<p>36000-550</p> <p>Library Books Expense</p> <hr style="width: 100%;"/> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; border-right: 1px solid black; padding: 5px;">300</td> <td style="width: 50%; padding: 5px;">300</td> </tr> </table>	300	300	<p>36000-510</p> <p>Library Supplies Expense</p> <hr style="width: 100%;"/> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; border-right: 1px solid black; padding: 5px;">300</td> <td style="width: 50%; padding: 5px;"></td> </tr> </table>	300	
300	300				
300					

The result would be that the Books Expense account would be \$0, while the Supplies Expense would now be \$300. Rather than using T accounts, most organizations have forms for correcting errors through journal entries; one line showing the accounts to be debited and credited is common. The following illustrates the previous example on a form that might be used:

JOURNAL ENTRY FORM	Date _____	
Item	Debit Account	Credit Account
Correct accounting error	36000-510	36000-550

Prepared by: _____
 Authorized by: _____

After this journal entry is recorded, it will be posted to the ledger and corrections would show on later reports.

This section has introduced some of the traditional methods of recording accounting transactions. Although paper ledgers and journals, traditionally called "the books," may no longer be in use in many businesses, the terminology is still used both in manual bookkeeping systems and in computerized accounting systems. Even when entries are made into computer systems, some "paper trail" is usually needed to locate the original transactions. With computerization, many of the manual entries just described are programmed into the system, so a single data entry process may create several other entries and update several accounts, keeping the system in balance at all times.

The Closing Process

Revenues and expenses are usually measured for specific time periods, such as a fiscal year, with interim accounting reports to track progress throughout the year. By tracking revenues and expenses for a fiscal year, businesses can establish specific time periods for preparing reports, reviewing progress, comparing with previous time periods, and beginning a new year. Since revenue minus expense equals net income, the revenue and expense accounts are *closed* at the end of each year, and the resulting net income is added to the equity of the organization. For this reason revenue and expense accounts are considered temporary accounts, while asset, liability, and equity accounts which carry balances from one time period to the next, are considered permanent accounts.

During the "closing process," the necessary adjustments must be made to the accounts to assure all revenues that have been earned and all expenses that have been incurred have been recorded in "the books." At this time it is particularly important for your information center to record activity accurately so you will be able to correctly identify which expenses (and possibly revenues) belong in which fiscal year. As we previously noted, if your organization's fiscal year ends on December 31, an order received on December 31 would be recorded as an expense in one fiscal year, while an order received on January 1 would be recorded as an expense in the next fiscal year. While it might not make much difference if a book order or furniture item is noted as being received on April 30 or May 1, it may make a difference at the end of the fiscal year.

This process of updating the accounting system for the preparation of accurate financial reports may be very time-consuming

Summary

For several hundred years, accountants have used the double-entry system to record business transactions in a systematic manner. This method assures that an accounting system is always in balance, and there is continual recording of revenues and expenses, and assets and liabilities, with corresponding changes to equity -accounts. The use of T accounts provides a graphic illustration of how the double-entry system works.

For each accounting transaction, information is first recorded in a journal and then posted to a ledger that eventually provides a history of each account. Because the matching rule of accounting states that revenue must be recorded in the time period it is earned, and expenses must be recorded in the time period they are incurred, adjustments must be made at the end of each accounting period to record items not included in the cash basis of accounting.

Chapter V

Communicating Financial Information

Without a means to communicate information to users, accounting systems would not be very useful. The primary method of communicating this information is through the use of written reports, with information sorted and arranged in a manner intended to be useful to selected audiences.

For internal users, reports may be designed to provide exactly the information needed; in fact, many organizations have hundreds of different reports to provide precise information to specific users. Internal reports are usually *management reports*, and are designed to provide financial information in a way to make it useful for decision making. Comparisons of actual expenses to budget, comparisons of actual sales to expected sales, reports of revenue and expense by product group or department - these are only a few examples of reports that may be used in an organization to make financial decisions for the future.

One of the most common internal management reports is a *budget report*, showing actual amounts, budgeted amounts, and the balance available to spend. These reports reflect the actual accounting activity for a specific time period, and any questions usually need to be discussed with the accounting department. Following is a simple illustration of a budget report:

LIBRARY BUDGET REPORT

Account 36000

Code	Item	Budget	Current Month	Year-to-Date	Balance Available
100	Salaries Expense	150,000	12,000	72,000	78,000
200	Benefits Expense	45,000	3,600	21,600	23,400
300	Supplies	5,000	800	3,000	2,000
400	Travel	1,500	600	1,200	300
520	Periodicals	4,000	700	3,100	900
550	Books	30,000	3,000	21,000	9,000
600	Computer Services	9,000	1,000	5,000	4,000
700	Furniture & Equipment	8,000	500	4,500	3,500
	Total	252,500	22,200	131,400	121,100

Reports of this type are useful for managers within the company, who need to be certain they are not spending more than the

External reports, or financial statements, for those outside the organization, must be understandable to a wide range of users. Investors, creditors, donors and many others need information on the financial condition of the organization. For this reason, external reports follow standard formats and are designed according to generally accepted accounting principles. Occasionally the Financial Accounting Standards Board issues new guidelines for financial reports, and these guidelines should be followed by all business organizations.

The Balance Sheet

The most basic of the financial reports, and the one most similar among different organizations, is the balance sheet. We previously discussed the “balance sheet equation,” stating that “Assets = Liabilities + Equity.” This equation, with “assets” on the left side and “liabilities + equity” on the right, is similar in format to the balance sheet, which displays assets on the left side and liabilities and equity on the right. A balance sheet shows the financial position of an organization at a particular time; the date is shown at the top of the balance sheet. Reviewing your organization’s balance sheet can provide you with valuable information on the financial situation of your company. You can clearly see the total assets in relation to the total liabilities of the company, along with information identifying the nature of these assets and liabilities. Following is an example of a balance sheet:

Jones Corporation Balance Sheet December 31, 19xx			
	Assets		Liabilities
Cash	\$ 1,000		Accounts Payable
Accounts Receivable (net)	1,200		\$ 2,500
Land	2,000		Mortgage on Building
Building	10,000		5,000
Equipment	6,000		Owner’s Equity
	\$ 20,200		John Jones, Capital
			12,700
			\$ 20,200

In the balance sheet above, assets are listed on the left side. Note that current assets, such as cash and accounts receivable, are listed first; these are the assets expected to be most available to the company. Cash is already on hand or in the bank; accounts receivable are payments due from customers and are expected to be collected in the near future. Because a small percentage of the accounts receivable will probably never be collected, it is shown as a net figure, meaning the total is reduced by an amount likely not to be collected. Assets such as land, buildings, and equipment are long term assets not expected to be converted into cash in the near future.

On the liability side of the balance sheet, the same pattern exists. Accounts payable are outstanding bills already due, such as payments for book orders or equipment recently received. The mortgage, which probably is not expected to be paid off in the near future, is a long-term liability and is shown after any current liabilities. As previously stated, assets and liabilities expected to last longer than one year are considered long-term, while those expected to last less than one year are short-term, or current, assets and liabilities.

In addition to the information on the previous balance sheet, most corporate balance sheets show comparable information for a previous time period-usually the end of the previous fiscal year. Because of this additional information, and because of space limitations and paper sizes, it is not always possible to show all assets on the left side of a page, and liabilities and equity on the right. For this reason it is more common to see a balance sheet with assets listed at the top and liabilities and equities listed at the bottom, clearly showing these two areas are equal. The following example illustrates a balance sheet for a large corporation, showing comparable information for the previous year. Also note that dollar amounts are shown in millions; for example, the amount of cash and temporary cash investments as of December 31, 1993, was \$399,000,000. As you can see, showing these figures in terms of millions of dollars makes the balance sheet much easier to read; in order to do this, of course, these numbers must be rounded to the nearest million dollars.

By looking at a balance sheet of your organization, you may be able to determine the company’s current financial position.

XYZ Corporation
Balance Sheet

	Dec. 31 1993	Dec 31 1994
	(in Millions)	
Cash and temporary cash investments	\$ 399	\$ 322
Other current assets	5,102	5,621
Property, plant, and equipment, net	28,560	28,700
Investments and other assets	7,295	6,898
Total assets	\$41,356	\$41,541
Liabilities and Shareholders' Equity		
Short-term obligations, including current maturities	\$ 1,914	\$ 1,644
Other current liabilities	6,022	6,200
Long-term debt	12,285	13,009
Other long-term liabilities	11,362	11,031
Shareholders' equity	9,733	9,657
Total liabilities and shareholders' equity	\$41,356	\$41, 541

The Income Statement

Another important financial statement is the *Income Statement*, displaying the company's revenues and expenses for the previous time period, and the resulting net income. Following is an example of an income statement:

Jones Bookstore
Income Statement
For the Year Ended December 31, 19xx

Revenue	
Book Sales	\$95,000
Magazine Sales	5,000
	100,000
Gross Sales	
Cost of Goods Sold	54,000
Gross Profit from Sales	\$46,000
Expenses	
Salaries	\$19,000
Rent	7,200
Utilities	2,400
Telephone	500
Supplies	350
Advertising	1,000
	\$30,450
Total Expenses	
Net Income	\$15,550

The previous example illustrates a simple income statement from a bookstore, typical of a small sales operation. Gross revenues from sales are shown, often by product line, and the cost of the product sold is then subtracted to arrive at a net sales figure. In a manufacturing business, the cost of the product sold includes all costs to manufacture it, while in a sales business, the cost includes costs to purchase the items to be sold. In a service business, where only services are sold (for example, a legal or accounting firm), “cost of goods sold” is not relevant and is not part of the income statement.

Because the income statement reflects the specific activities of the business, a great deal can be learned about a company from its income statement. There is considerable variation among companies as to the items shown on the statement, but the basic items are net revenues, expenses, and net income.

It is important to note that while the balance sheet shows a company’s financial position at *one point in time*, the income statement shows activity over a *period of time*. Following is an example of an income statement from a large corporation:

ABC Corporation
Income Statement
For the Period Ending
December 31, 19xx

	12/31/94	12/31/93
	(in millions)	
Net sales	\$ 18,060	\$ 15,021
Cost of goods sold		
Beginning inventory	4,000	4,500
Purchases	11,000	10,000
Total goods available for sale	15,000	14,500
Less ending inventory	(3,000)	(4,000)
Cost of goods sold	12,000	10,500
Gross profit from sales	\$ 6,060	\$ 4,521
Operating expenses		
Salaries	\$ 1,000	\$ 950
Other expenses	750	675
Total operating expenses	\$ 1,750	\$ 1,625
Net income from operations	\$ 4,310	\$ 2,896

The preceding income statement shows net sales for two comparable years, and also gives information about the product sold. (Because a certain number of items sold are returned for a refund, net sales shows the amount after returns.) There was inventory on hand at the beginning of the year, and more products, or “goods,” were purchased during the year. The sum of the inventory on hand plus the purchases were the total goods available for sale. Not everything was sold, since there was some inventory left at the end of each year, so this amount is subtracted from the total to arrive at the total “cost of goods sold” for the year. Note the ending inventory for the previous year is the same as the beginning inventory for the current year, as it should be.

The Statement of Financial Position

The income statement shows the company’s net income (or loss) from operations, but does not include many other significant financial events. Some assets may have been bought or sold; owners may have added or removed capital from the business; new liabilities may have been incurred or old ones paid off. The *Statement of Changes in Financial Position* is used to show all changes in financial position during an accounting period, including net income and other investing or financing activities. Following is a brief *Statement of Financial Position*.

Jones Bookstore
Statement of Changes in Financial Position
For the Year Ended December 31, 19xx

Sources of Financial Resources

Net Income		\$15,500
Investment by M. Jones, Owner		5,000
Sale of Equipment		1,000
		\$21,550
Total Sources		\$21,550

Uses of Financial Resources

Purchase of Equipment	\$4,000	
Repayment of Loan		10,000
		\$14,000
Total Uses		\$14,000

Increase in Financial Resources

\$7,550

Notes to Financial Statements

The balance sheet, the income statement, and the statement of changes in financial position all provide important information about a company and its financial operations. As you can see, the format of the financial statements limits the type of information that can be easily included, yet it is important for the information to be complete. Because full disclosure is required, accountants use *Notes to Financial Statements* to provide additional information when necessary. For example, the notes may provide information on accounting policies, property and equipment, lease and mortgage agreements, pension and profit-sharing plans, and a variety of other information.

If you have access to the financial statements of your company, you should find them very interesting. The notes, in particular, often provide an enormous amount of detailed information about a company and its operations.

Summary

This chapter has provided a brief introduction to some basic financial statements. The balance sheet shows the financial position of a company at a specific point in time, displaying assets on one side and liabilities and equity on the other. The income statement provides information concerning the previous year's revenues, expenses, and net income, while the statement of financial position includes supplemental information on other financial activities during the year. Notes to the financial statements provide additional information not conveniently shown in the body of the statements.

Because consistency is required in financial reporting, it is possible to compare a company's financial activity between time periods. Generally accepted accounting principles require most companies to prepare statements similar to these so they may be readily understood by many people, and so comparisons may be made between similar companies.