ACCT 100 - Intro to Acct.

Chapter 13 - Financial Statements, Closing Entries and Reversing Entries

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Where we have been: We are almost finished learning a complete accounting cycle for a merchandising enterprise. We have learned how to record buy and sell transactions. We have reviewed the adjustment process and learned quite a few new adjusting entries. We then reviewed the preparation of the worksheet. This brings us to the summarizing process of the accounting function.

Where we are going: This chapter will introduce you the financial statements for a merchandiser and how to prepare the closing entries for a merchandiser. It will also introduce you to reversing entries, which we will not cover.

Financial Statements

The same three financial statements that we learned for a service-oriented enterprise will also be used for a merchandiser. However, they will look different. The main difference and the main challenge will be the preparation of a multi-step income statement. See the separate handout of the skeleton based multi-step income statement for additional help. To refresh your memory, the three main financial statements that you will need to prepare are:

- The Income Statement
- The Statement of Owner's Equity
- The Balance Sheet

As you will recall, they need to be prepared in this prescribed order, because the contents of one follows the next. Don′t forget, the source for your financial statement will be from the worksheet!

Income Statement

You should pull your final numbers for the income statement from the worksheet columns. As discussed previously, a vast majority of merchandising companies use the multi-step format of an income statement. The Cost of Good Sold will be the most challenging part of this worksheet. This Income Statement in its skeleton form looks like this:

Net Sales

Less: Cost of Goods Sold

Gross Profit

Less: Operating Expenses

Income from Operations

+\- Other Income or Expense

Net Income

Your need to know how to compute each part of the income statement before you can attempt to compute a full blown one. We will practice these parts in depth in the class:

Net Sales = Sales - Sales Discounts - Sales Ret. & Allow.

COGS = Beg Inv + Net Purchases + Freight In - Ending Inventory
(Everything that you bought)

COGS shown in detail:

Beginning Inventory			
Add:	Net Purchases		XXX
	Purchases	XXX	
	Less Purch Ret/Allo	(xxx)	
	Less Purch Discount	(xxx)	
	Net Purchases	XXX	

Add	Freight In	XX	
Cost of Goods Delivered			XXX
Cost of Goods Available for Sale			XXX
Less:	Ending Inventory		(XXX)
Cost of Goods Sold			XXX

Gross Profit = Net Sales - Cost of Goods Sold

(This amount is very important to all merchandiser and remains consistent form month to month as a percentage of sales.)

Operating Expenses = Selling Expenses & General or Administrative Expenses

The selling expenses are those expenses directly related to the selling function. They include any sales salaries, commissions, advertising, depreciation of store equipment, etc. The General and Administrative expenses are all the other day-to-day operating expenses not related to the sales function and include the salaries of clerical workers, finance people, rent, utilities, general office supplies, business insurance etc.

Income from Operations: This is just a subtotal which is equal to Gross profit - Operating Exp. This subtotal represents the amount the company earned or lost before any other non-recurring items happened.

Other Income or Expense: Other income is any other revenue besides sales. This will include interest income, rental income, dividend income received from other companies, or any gains on sale of an asset. Other expenses include non-operating or non day-to-day expenses. The most common are interest expenses and losses from sales of assets.

As stated previously, you MUST KNOW HOW TO PREPARE this multi-step income statement. You need to practice, practice, and practice. You will also prepare this many times over in your next accounting class, ACCT 101.

Statement of Owner's Equity

No change here. The statement of looks exactly the same for both types of businesses. Remember format:

Beginning Capital		XXX
Add: Additional investments, if any		XXX
Subtotal		XXX
Add: Net Income	XXX	
Less: Withdrawals	(XXX)	
Net Increase		XXX
Ending Capital		XXX

The Balance Sheet

The Balance sheet will look very much the same. The only change is now you will be required to **classify** your balance sheet. (Almost all companies - even service enterprises - do this. This text just waited to introduce the concept of classification until now. What does a classified balance sheet look like? The assets are classified into current assets and plant assets. A current asset is an asset that turns over or is realized within a year. As you know, these assets are listed in order of liquidity, or how fast they can be converted to cash. Plant assets are those long-lived assets that we have been talking about. Common plant assets are Buildings, Land, Autos, Equipment, Machinery, and the like. Some people also call these plant assets "fixed assets.

Liabilities are classified into current liabilities and non-current or long-term liabilities. Current liabilities are those liabilities that are due and payable within a one-year time frame. Accounts Payable, most notes payable, salaries payable are common examples of current liabilities. Long-term liabilities are those liabilities that do not come due during the next 12 months. Most mortgage payables, some loans and some notes are considered long term.

Why bother with these new-fangled statements?

Well, there are several good reasons to learn these: 1) To pass the next test, 2) because that's what the financial statements in real world look like, 3) because many common financial ratios and analyses will use components from these statements, 4) because you will have money to invest someday and need to learn what some key ratios mean so you can make an informed investment choice.

Some Common financial analysis stuff

Gross Profit percentage shows the amount of gross profit earned per each sales dollar.

Gross Profit = Net Sales - COGS and shown as a percentage would be Gross Profit/Net Sales

Working Capital is the difference between current assets and current liabilities. (See why we need a classified balance sheet?) The amount of working capital is of key concern to management and to anyone loaning the company money. It tells whether the company has sufficient day-to-day resources to run its operations. This can be expressed in two ways:

In dollars: **Working Capital** = Current Assets - Current Liabilities

OR

As a percentage (which is called the current ratio) which is much more meaningful:

Current Ratio Current Ratio = CA / CL

Bankers like to see a ratio of 2 to 1. This means that the company has 2 dollars in current assets for each 1 dollar of current debt.

Inventory Turnover shows the number of times inventory has been replaced or "turned over" during the year. It is calculated as COGS/Avg. Inventory. This ratio varies widely by industry. For example, someone that makes food would have a much higher turnover that someone that makes diamond rings as one is perishable and one isn't. This turnover can be compared between years within the same company and also to competitor's ratios.

Accounts Receivable Turnover – shows the number of times accounts receivable have been repaid or "turned over" during the year. It is calculated as Net Sales / Avg. AR. This ratio varies based on the terms of sale provided by the company. This turnover can be compared between years within the same company and also to competitor's ratios.

<u>Closing Entries (We must be near the end!)</u>

Remember why we need closing entries:

- To close out nominal accounts in order to be ready for the next new fiscal year
- To transfer net income and drawing to the owner�s capital account.

The purpose of doing the closing entries has not changed. We just need to tweak the process a little.

For Service Business	**For Merchandisers**
Close revenues	Close Income Stmt accounts with credits
Close expenses	Close Income Stmt accounts with debits
Close Income Summary	Close Income Summary ***
Close Drawing	Close Drawing

***Don't forget to make a t-account because this account has some balances in it now from the inventory adjustment. This should match the net income or loss.

That's It. As usual, we will demonstrate all of this in class. There are a lot of terms in this chapter. Be sure you go over them. The most important part of this chapter is your ability to prepare a set of financial statements for a merchandiser.

Reversing Entries - Not covered